

**MEXICO**

**RURAL FINANCIAL SYSTEM CONSOLIDATION PROGRAM**

**(ME-0243)**

**LOAN PROPOSAL**

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## **BASIC SOCIOECONOMIC DATA**

For basic socioeconomic data, including public debt information, please refer to the following address:

<http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata>

## INFORMATION AVAILABLE IN THE RE2/FI2 TECHNICAL FILES

### **Preparation:**

Ley Orgánica de la Financiera Rural [Act Establishing Financiera Rural], entered into force: December 2002

Ley de Ahorro y Crédito Popular [Savings and Popular Credit Law]

BANRURAL financial statements, 1999-2002

World Bank policy matrix

Consultancy report, Juan Buchenau, “Los servicios financieros rurales y las políticas estatales para su promoción en México [Rural financial services and government policies advancing them in Mexico],” December 2002

Five-year financial projections

Charter

Operational and lending manuals

Risk modeling proposal

Loan contract

## ABBREVIATIONS

BANRURAL	Banco Nacional de Crédito Rural SNC [National Rural Credit Bank]
BANSEFI	Banco de Ahorro Nacional y Servicios Financieros [National Savings and Financial Services Bank]
CNBV	Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission]
CONASUPO	Compañía Nacional de Subsistencias Populares [National Popular Subsistence Company]
DOFI	Departamento de Organismos Financieros Internacionales [International Financial Agencies Department]
EACPs	Entidades de Ahorro y Crédito Popular [savings and loans institutions]
FIDELIQ	Fideicomiso Liquidador de Instituciones y Organizaciones Auxiliares de Crédito [Trust Fund for the Liquidation of Auxiliary Credit Institutions and Organizations]
FIRA	Fideicomiso Instituido en Relación con la Agricultura [FIRA agricultural trust fund]
FOBAPROA	Fondo Bancario de Protección al Ahorro [Bank Savings Protection Fund]
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
IPAB	Instituto de Protección del Ahorro Bancario [Bank Savings Protection Institute]
LOFR	Ley Orgánica de Financiera Rural [Act Establishing Financiera Rural]
MIF	Multilateral Investment Fund
NAFIN	Nacional Financiera SNC
NAFTA	North American Free Trade Agreement
NGO	Non-governmental organization
PAHNAL	Patronato del Ahorro Nacional [National Savings Foundation]
PROCAMPO	Programa de Apoyos Directos al Campo [Direct Rural Support Program]
PROCEDE	Programa Nacional de Certificación de Derechos Ejidales y Titulación de Solares Urbanos [National Ejido Rights and Land Title Certification Program]
PROCREPA	Programa de Crédito a la Palabra [“Word of Honor” Credit Program]
SAGARPA	Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación [Secretariat of Agriculture, Livestock, Rural Development, Fisheries and Food]
SEA	Servicio de Administración y Enajenación de Bienes [Asset Management and Disposal Service]
SHCP	Secretaría de Hacienda y Crédito Público [Secretariat of Finance and Public Credit]
SIEBAN	Sistema de Estímulos a la Banca [Banking Incentive System]
SOFOLES	Sociedades Financieras de Objeto Limitado (mortgage banks)
UDI	Unidad de inversión [investment unit] (a unit of account that maintains a real constant value)



# MEXICO

## IDB LOANS

APPROVED AS OF AUGUST 31, 2003

	US\$Thousand	Percent
<b>TOTAL APPROVED</b>	<b>16,314,104</b>	
DISBURSED	13,929,912	85.38 %
UNDISBURSED BALANCE	2,384,192	14.61 %
CANCELATIONS	1,215,049	7.44 %
PRINCIPAL COLLECTED	6,845,661	41.96 %
<b>APPROVED BY FUND</b>		
ORDINARY CAPITAL	15,701,209	96.24 %
FUND FOR SPECIAL OPERATIONS	558,986	3.42 %
OTHER FUNDS	53,910	0.33 %
<b>OUTSTANDING DEBT BALANCE</b>	<b>7,084,251</b>	
ORDINARY CAPITAL	7,039,866	99.37 %
FUND FOR SPECIAL OPERATIONS	28,291	0.39 %
OTHER FUNDS	16,093	0.22 %
<b>APPROVED BY SECTOR</b>		
AGRICULTURE AND FISHERY	4,240,589	25.99 %
INDUSTRY, TOURISM, SCIENCE AND TECHNOLOGY	2,092,322	12.82 %
ENERGY	745,454	4.56 %
TRANSPORTATION AND COMMUNICATIONS	814,227	4.99 %
EDUCATION	625,574	3.83 %
HEALTH AND SANITATION	1,531,780	9.38 %
ENVIRONMENT	99,482	0.60 %
URBAN DEVELOPMENT	940,357	5.76 %
SOCIAL INVESTMENT AND MICROENTERPRISE	2,223,397	13.62 %
REFORM AND PUBLIC SECTOR MODERNIZATION	2,329,228	14.27 %
EXPORT FINANCING	359,413	2.20 %
PREINVESTMENT AND OTHER	312,281	1.91 %

\* Net of cancellations with monetary adjustments and export financing loan collections.



## Mexico

### Tentative Lending Program

#### 2003

Project Number	Project Name	IDB US\$ Millions	Status
ME0238	Community Education	210.0	APPROVED
ME0243	Consolidation Financial System	300.0	
ME0255	Urban Poverty and Social Evaluation Program	350.0	
<b>Total - A : 3 Projects</b>		<b>860.0</b>	
ME0253	Demonstrative management models potable water and sanitation	10.0	
<b>Total - B : 1 Projects</b>		<b>10.0</b>	
<b>TOTAL 2003 : 4 Projects</b>		<b>870.0</b>	

#### 2004

Project Number	Project Name	IDB US\$ Millions	Status
ME0250	Competency-based Human Resources Development	80.0	
ME0245	Health and Pension for Government Workers	275.0	
ME1004	Training and Employment Support Program Phase II	300.0	
ME0257	Irrigation District Technification	80.0	
ME0212	Water and Sanitation in Rural Zones II	300.0	
ME0259	Public Financial System Consolidation	300.0	
*ME1001	Carretera Oriente del Estado de Mexico	75.0	
*ME1003	Hipotecaria Nacional- Mortgages Asset Backed Security	50.0	
<b>Total - A : 8 Projects</b>		<b>1,460.0</b>	
ME0256	Strengthening States and Municipalities II	300.0	
ME0240	Small Exporters Finance Program	300.0	
ME1002	Technology to support Education	200.0	
ME1005	Direct Support to States	100.0	
<b>Total - B : 4 Projects</b>		<b>900.0</b>	
<b>TOTAL - 2004 : 12 Projects</b>		<b>2,360.0</b>	

**Total Private Sector 2003 - 2004 125.0**

**Total Regular Program 2003 - 2004 3,105.0**

**\* Private Sector Project**





# MEXICO

## STATUS OF LOANS IN EXECUTION AS OF AUGUST 31, 2003

(Amount in US\$ thousands)

APPROVAL PERIOD	NUMBER OF PROYECTS	AMOUNT APPROVED*	AMOUNT DISBURSED	% DISBURSED
<b><u>REGULAR PROGRAM</u></b>				
Before 1997	1	365,000	3,164	0.87 %
1997 - 1998	2	333,400	205,047	61.50 %
1999 - 2000	4	1,405,000	1,030,384	73.34 %
2001 - 2002	4	2,100,000	810,582	38.60 %
2003	1	210,000	0	0.00 %
<b><u>PRIVATE SECTOR</u></b>				
1999 - 2000	1	75,000	62,827	83.77 %
<b>TOTAL</b>	<b>13</b>	<b>\$4,488,400</b>	<b>\$2,112,004</b>	<b>47.05 %</b>

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\* Net of cancellations. Excludes export financing loans.

# RURAL FINANCIAL SYSTEM CONSOLIDATION PROGRAM

(ME-0243)

## EXECUTIVE SUMMARY

<b>Borrower:</b>	United Mexican States	
<b>Executing agencies:</b>	Secretariat of Finance and Public Credit [Secretaría de Hacienda y Crédito Público (SHCP)] and Financiera Rural.	
<b>Amount and source:</b>	IDB: (Ordinary Capital)	US\$300 million
	Total:	US\$300 million
<b>Financial terms and conditions:</b>	Amortization period:	15 years
	Grace period:	5 years
	Disbursement period:	36 months
	Interest rate:	Variable
	Inspection and supervision:	1%
	Credit fee:	0.75%
	Currency:	United States dollars, Single Currency Facility
<b>Objectives:</b>	<p>The program's objective is to expand and consolidate the supply of financial services for rural sectors. Its specific objectives are to: (i) increase the efficiency of the tools used by the government in working with the rural sector by liquidating the National Rural Credit Bank [Banco Nacional de Crédito Rural SNC (BANRURAL)] system and establishing Financiera Rural, as well as tighten coordination among the various government programs; and (ii) improve conditions for the development of bank and nonbank financial intermediaries in rural areas.</p>	
<b>Description:</b>	<p>The Bank will support the rural financial system consolidation program with a policy-based loan. The loan will be disbursed in two equal tranches no less than 18 months apart. In order to meet its stated objectives, the program has been divided into two components: (i) implementation of measures for increasing coordination among the various State programs in the sector; and (ii) liquidation of the BANRURAL system and the establishment of Financiera Rural.</p>	

**The Bank's country and sector strategy:**

The proposed program is in keeping with the Bank's country strategy with Mexico as set forth in country paper GN-2181. This strategy makes specific mention of the need to continue working to heighten the public development banking system's efficiency and to improve the operations of savings and loan institutions in those segments that work the most with the poor. The World Bank has approved a concurrent US\$505-million operation to support the establishment of Financiera Rural.

**Coordination with other multilateral development agencies:**

The IDB and World Bank teams have been working in close collaboration with one another. The World Bank's orientation differs from, yet complements, this program's line of work, as it focuses primarily on the overall reform of the development banking system while addressing some specific aspects of the campaign to reform the BANRURAL system. The collaboration between these institutions has permitted the organization of joint missions and the formation of a working team composed of staff members from both. This mode of operation has enabled the two institutions to coordinate their approach to the issues to be addressed and keep their operations in close alignment (paragraph 4.27).

**Environmental and social review:**

The program will have no direct environmental impacts, since all its activities focus on institutional and legal reforms in the financial sector. Financiera Rural could, however, have some environmental impact, since it will be called upon to determine what types of activities can be financed. As part of the program, steps will therefore be taken to ensure that the environmental dimension is integrated into the design of this new institution's products and strategy. The Committee on Environment and Social Impact approved the operation at its meeting of 7 February 2003.

**Benefits:**

At present there are many government programs dealing with rural financial services that do not share the same objectives and that, in many cases, compete with each other outright. Closer coordination among the various programs could substantially improve the efficiency of public expenditure in this area and increase the impact it has on the development of rural financial intermediaries.

The program will support the transition from an unviable financial intermediary (since the present institution operates at a high cost to the government and has a deleterious effect on the rural financial market) to a new agency, Financiera Rural. Financiera Rural's governance structure is conducive to its independence, will diminish the influence of political considerations in its decision-making, and will promote a suitable use of fiscal resources. In addition, one of its duties is to foster the development of financial markets.

**Potential risks:** The process involved in founding the Financiera Rural is being pursued within the framework of a complex dialogue between the government and campesino organizations that feel that their interests are threatened by the forthcoming reduction in tariffs under the North American Free Trade Agreement (NAFTA). Concern about the future of the rural sector and, in particular, of the agricultural sector could end up exerting political pressure on Financiera Rural to disburse its funds rapidly. This could jeopardize the new institution's viability, since a rapid expansion of lending operations is very risky, especially for a newly founded organization. In order to mitigate this risk, it has been agreed that Financiera Rural is not to increase its lending operations by more than 10% above BANRURAL's lending level during the second half of 2003 with respect to the level granted by BANRURAL in the second half of 2002. In addition, in preparation for disbursement of the second tranche, its risk assessment systems will be analyzed by an independent consultant in order to determine whether these systems are adequate to manage the risk associated with an expansion of the institution's loan portfolio.

Direct government intervention in rural credit markets is a high-risk venture, and the results to date have not been very encouraging. The authorities expect that, initially, Financiera Rural will continue to provide first-tier credit services. There are two reasons for this: (i) as a result of the disappearance of BANRURAL, a considerable number of borrowers would otherwise be deprived of credit services (and experience shows that the emergence and development of private intermediaries is a slow process that calls for a great deal of backstopping, even in the absence of public lenders); and (ii) the issue of rural credit services has important political implications. A suspension of first-tier services, in the absence of a transitional solution, would not be politically viable. The governance structure of Financiera Rural, the independence of the lending process, training and incentives for staff members, and the introduction of sophisticated risk models constitute the foundation upon which senior management expects to build a successful organization.

There is a risk that the government policy of subsidizing various programs' interest rates will limit Financiera Rural's ability to charge interest rates that will cover its costs. In addition, the continuation of those subsidies could crowd out private intermediaries. In its policy letter, the Government of Mexico has committed itself to reviewing interest-rate subsidies with a view to phasing them out. The government will also develop a strategy for coordinating the various programs that are now in place. This strategy will take into account the effects of these programs on the development of private intermediaries.

In the medium term, Financiera Rural will have a conflict of interest between the provision of credit services to the rural sector and the development of first-tier financial intermediaries. Its success or failure as an institution will depend largely on whether it resolves that conflict satisfactorily. Financiera Rural has committed to take steps at the level of its organizational structure and procedures that would lessen conflicts of interest between first- and second-tier operations. Financiera Rural's interest-rate policy should also be consistent with the objective of increasing private intermediaries' market share in rural areas.

**Special contractual clauses:**

The loan will be disbursed in two tranches of US\$150 million each, subject to compliance with the conditions set out in Annex II (Policy Matrix). The loan contract will also include the terms and conditions pertaining to the disbursement procedures outlined in paragraphs 5.2 and 5.3 of this document.

**Special condition on execution.** As a condition precedent to disbursement of the first tranche of the loan, an agreement must have been entered into, and be in force, between the borrower and Nacional Financiera, SNC (NAFIN), enabling NAFIN to act as managing agent for the program and perform the functions described in Section V.

**Poverty-targeting and social sector classification:**

This operation does not qualify as a rural-poverty-targeted investment (PTI) as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704). However, the measures planned for this operation do have the potential to produce a major impact in terms of the reduction of rural poverty (paragraph 4.28).

**Key performance indicators and benchmarks:**

The indicators include principal market operator figures for: average loan amount; portfolio breakdown by amount; number of first-tier customers; first-tier total portfolio; number of end customers through first-tier institutions; number of first-tier institutions served; second-tier total portfolio; loans over 30 days past due; first tier; second tier; annualized portfolio charge-offs/average portfolio; percentage of portfolio at rates with explicit subsidies (number and amount); portfolio return; SDI index.

**Exceptions to Bank policy:**

None.

**Procurement:**

The fast-disbursing component of the loan may be used to support the borrower's public finances and balance of payments, subject to the restrictions of Bank's policies. In this event, Bank procedures for sector loans as set forth in document GN-2001-2 will apply. These procedures do not require an international competitive bidding process. The funds will be disbursed at the borrower's request upon submission of evidence of the fulfillment of all contractual conditions to the Bank's satisfaction.

## **I. FRAME OF REFERENCE**

### **A. Introduction**

- 1.1 The Government of Mexico has been reforming the country's development banks in an effort to improve their governance structures, risk management, and efficiency. At the same time, as the move to lift tariffs under the North American Free Trade Agreement (NAFTA) proceeds, the agricultural sector has reemerged as an important focus of the government's economic policy. Within this context, the Mexican authorities and the Bank have engaged in constructive dialogue on financing to rural sectors and the government's role in providing and promoting financial services in rural areas. The proposed operation supporting government reforms in the sector is an outcome of that dialogue.

### **B. The economic situation**

- 1.2 The economic slowdown in the United States has had a strong impact on the Mexican economy, which has witnessed a marked decline in the growth of both domestic demand and manufacturing activity as less disposable income is being spent. Economic activity began to slacken in the final quarter of 2000 and weakened further in 2001, when GDP declined by 0.3% in real terms. Economic activity picked up by a modest 0.9% in 2002, buoyed by an increase in consumer spending (0.9%) and a slight upturn in exports. As the year drew to a close, however, the growth of private consumption slowed substantially. Annual inflation fell to 5.7% as of end-2002—well below the 6.5% target rate—but underlying inflation, which strips out products with highly volatile prices, dropped from 5.1% at end-2001 to 2.1% in 2002. At the close of the first half of 2003, gross international reserves totaled US\$53.4 billion, well in excess of the country's short-term debt of under US\$4 billion, and approaching the US\$74 billion figure for the public sector's total external debt. The fiscal deficit was 1.25% of GDP in 2002, far above the 0.65% initially authorized by Congress. The increase was due entirely to budget additions to cover the cost of closing the National Rural Credit Bank [Banco Nacional de Crédito Rural SNC (BANRURAL) and starting up operations of Financiera Rural.

### **C. The rural economy**

- 1.3 **The agricultural sector** accounted for just 3.8% of GDP in 2002 as compared to 7.5% in 1995. The primary agricultural sector posted an average annual economic growth rate of 1.6% for the period from 1990 to 2000, trailing the economy as a whole (3.4%), agribusiness (3.7%), and even population growth (1.8%). In 2002, the sector grew by a mere 0.4% owing to the widespread weakness of external markets, which hurt Mexican exports, and bad weather conditions, which led to a reduction in the amount of land harvested and sown with many of the crops grown in the country.

- 1.4 This sector still employs nearly 21% of the labor force, however. The rural population is scattered among around 190,000 small towns or villages of less than 2,500 inhabitants each. The agricultural sector provides work for a total of 8.7 million people in 3.7 million different production units; 1 million of these units are privately owned, while the other 2.7 million are run under an ejido or communal ownership system.<sup>1</sup> The performance level of these units varies enormously depending on their size, location, productive capacity, and other factors. The widely scattered nature of the rural population, coupled with low levels of investment, leads to serious shortfalls in economic infrastructure and basic services, which in turn fuel migration and make it both more difficult and more expensive to manage these rural economic units.
- 1.5 The slight upward trend in the agricultural sector's productivity per hectare harvested has not, in most cases, been reflected in higher income levels for producers, because the prices of farm produce have fallen in relation to price levels in the economy as a whole, and prices of inputs have risen. Whereas average productivity per hectare harvested rose by 5% between 1993 and 1999, the relative prices of primary agricultural products fell by 25%. In contrast, during the same period, processed food prices were 3% higher than the general price level in the economy.<sup>2</sup>
- 1.6 Agricultural activities represent an increasingly smaller share of rural income. According to data compiled by the National Statistical, Geographic and Informatics Institute [Instituto Nacional de Estadística, Geografía e Informática] (INEGI), only 17% of rural income is generated by farm businesses,<sup>3</sup> while persons who own no land make up 50% of the employed rural population. A large part of the rural population lives in poverty. In fact, 60% of rural households have per capita incomes of less than US\$2 per day, and the situation is even worse among indigenous populations and groups living in the most disadvantaged areas.
- 1.7 **As part of the economic reform process** that began in the 1980s, Mexico entered into the GATT (and later NAFTA), privatized State-owned enterprises, and deregulated the economy as a whole. In the rural sector, reforms were directed at scaling back State intervention and promoting the proper operation of the market. To these ends, the authorities did away with support prices (including those for corn

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<sup>1</sup> Unlike private property, owners of communal or ejido land cannot dispose of it or use it as collateral without the consent of the communal assembly or ejido council. Even with such consent, only the beneficial ownership of ejido land can be used as partial security for a loan.

<sup>2</sup> Data source: Sector Program for Agriculture, Livestock, Rural Development, Fisheries and Food [Programa Sectorial de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación] (SAGARPA) for 2001-2006. See [http://www.sagarpa.gob.mx/sectoriales/Programa\\_Sectorial.pdf](http://www.sagarpa.gob.mx/sectoriales/Programa_Sectorial.pdf).

<sup>3</sup> National Household Income and Expenditure Survey for the year 2000; at <http://www.inegi.gob.mx/difusion/espanol/fiepub.html>. This figure does not cover all forms of rural farm income, since it does not include earnings of farm employees.

and beans) and consumer subsidies (e.g., the price subsidy for tortillas was discontinued in January 1999), and tariffs on agricultural products were gradually lowered. In addition, the warehouses Almacenes Nacionales de Depósito, S.A. (ANDSA) and Bodegas Rurales de la Compañía Nacional de Subsistencias Populares (BORUCUNSA) [CONASUPO Rural Storage Facilities] were privatized.

- 1.8 Major reforms in the ejido system were also introduced, a land titling program was launched under the Ejido Rights and Land Title Certification Program [Programa de Certificación de Derechos Ejidales y Titulación de Solares Urbanos] (PROCEDE), and compensatory support measures were established under the PROCAMPO direct rural support program. PROCAMPO and the Alianza Contigo partnership program are designed to compensate small and medium-scale farmers for the income losses occasioned by changing market conditions and to facilitate technology transfer as a means of galvanizing production.
- 1.9 These initiatives' impacts on the sector have been mixed. On the one hand, they have paved the way for the development of a wide array of successful, specialized production activities. These activities cater to the local market and, at the same time, have resulted in a 70% increase in farm exports to the United States. On the other hand, many small and medium-scale producers have not managed to adjust to the new conditions existing in agricultural markets, and the large portion (60%) of the rural population that farms five hectares or less has not been able to break out of the vicious circle of low productivity and poverty. Because they lack a stable, sufficient income, the households in these segments of the population diversify their income by taking jobs, which often requires that they migrate, or in small-scale, non-agricultural activities.



## II. PRIVATE FINANCING FOR THE RURAL SECTOR

### A. Background

- 2.1 **Up to the end of the 1980s** government programs designed to expand the supply of financial services in rural areas relied heavily on the use of subsidies. These programs, whose cost had risen to 1.7% of GDP by the late 1980s, therefore placed a considerable financial burden on the public sector. The high claims rate for insurance operations (which reached 51%), the frequency of arrears, and the system's excessive operating costs (subsidies came to represent US\$0.89 per dollar of coverage), led the authorities to undertake a series of reforms. Measures adopted **in the early 1990s** in an effort to rationalize these agricultural support programs included the lifting of the requirement whereby banks had been obliged to devote a certain portion of their deposit funds to the agricultural sector and the disappearance of the agricultural insurer Aseguradora Nacional Agrícola (ANAGSA) and its replacement by AGROASEMEX as the issuer of insurance for production units. The segmentation of the market into three categories based on the production units' earnings, and the assignment of responsibility for serving these segments to different government lenders—the FIRA agricultural trust fund [Fideicomiso Instituido en Relación con la Agricultura] for the fastest-growing units, BANRURAL for small and medium-scale producers having productive potential, and the Social Development Secretariat's "Word of Honor" Credit Program [Programa Crédito a la Palabra] (PROCREPA) for producers in disadvantaged areas—helped to improve the organization of government action in the sector. Starting in 1995, the rates that financial intermediaries could charge the larger users of the FIRA program were deregulated, although limits remained in place for the rates applied to lower-income borrowers. These new arrangements did substantially reduce the fiscal cost of the federal government's support programs for the sector, but the fact remains that the amount of cultivated land having access to credit services shrank by 48% and the amount of land with insurance coverage plunged by 77% between 1988 and 1997.<sup>4</sup>
- 2.2 The financial crisis of 1994-1995 had a severe impact on private financial intermediaries serving the rural sector, whose already scant presence in that sector was thus reduced even further. Lenders whose operations drew primarily upon their own deposits weathered the 1995 crisis much better than those that relied on resources from other agencies. As a result, financial service providers' coverage of the rural sector today is far smaller than the coverage levels seen in other countries at a similar level of development. Generally speaking, the main bottleneck in the provision of financial (and, especially, credit) services in rural areas is the shortage

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<sup>4</sup> The continued reduction in the volume of credit that the financial system channels to the private sector in Mexico appears to indicate that this trend has strengthened in recent years.

of sustainable intermediaries that specialize serving small and medium-scale rural and agricultural entrepreneurs.

## **B. The commercial banking system**

- 2.3 The commercial banking system has traditionally been the principal supplier of financial resources for the country's economy. In recent years, however, the supply of financing for the private sector has contracted significantly in real terms, and the commercial banking system in Mexico is therefore seriously underperforming commercial banks in countries having a comparable level of development. Despite the steps taken by the government to restructure and capitalize the banking system, lending to the private sector has dropped off considerably since the financial crisis. Commercial bank lending accounts for approximately 30% of total financing received by the private sector; this is equivalent to just 8.9% of GDP, which is more or less the same level as registered in the mid-1980s.
- 2.4 There are a number of reasons for this trend: (i) the restructuring and consolidation that has been undertaken by most of the country's banks as part of their integration into international financial groups (nearly 80% of bank assets are accounted for by banks in which foreign investors hold a stake); (ii) the strengthening of risk assessment procedures, which has led lenders to be more selective in choosing among potential borrowers; (iii) a high degree of risk aversion, which has led to the belief that few potential borrowers have an acceptable risk profile; (iv) an ongoing disintermediation process; (v) competition from nonbank intermediaries, such as the countries' mortgage banks [Sociedades Financieras de Objeto Limitado] (SOFOL), which specialize in consumer loans and mortgages; and (vi) the preference of many firms for supplier credits and, in the case of export firms, for external credit.

**Table II-1**  
**Mexican bank portfolios**  
(in millions of 2003 constant Mexican pesos)

	1999	2000	2001	2002	2003 (March)
Total loan portfolio	1,300,442.90	1,157,952.11	1,030,362.17	1,042,911.60	980,025.14
Portfolio of loans outstanding	1,184,600.45	1,090,653.15	977,384.78	995,397.16	934,836.99
Commercial credit	350,182.78	349,106.54	305,511.49	311,253.72	290,240.87
Finance institutions	23,479.86	16,878.09	19,512.21	27,682.41	25,618.56
Consumer credit	38,077.09	44,240.65	57,844.03	77,383.69	76,785.92
Mortgages	151,782.07	138,444.60	121,746.23	116,118.05	106,081.43
Government agencies	121,373.42	187,381.81	171,924.21	215,370.83	206,885.31
IPAB/FOBAPROA	499,705.23	354,601.47	300,846.60	247,588.47	229,224.92
Nonperforming (gross)	115,842.46	67,298.97	52,977.39	47,514.43	45,188.15

**Source:** National Banking and Securities Commission [Comisión Nacional Bancaria y de Valores] (CNBV)

- 2.5 Commercial bank lending to the agricultural sector has also been hurt by this trend. For example, whereas the volume of commercial bank credit provided to the rural sector accounted for 7% of the total portfolio in 1993, commercial banking's share had slipped to 4.1% in 2000, when bank credit to the rural sector fell by 17%. This decline has not only continued, but has accelerated in recent months despite FIRA's efforts to channel resources through commercial banks. Thus, although commercial agricultural producers do not appear to have any difficulty in gaining access to commercial bank finance (funded with own resources), few banks are lending to producers seeking small loans, despite the subsidies under the Banking Incentive System [Sistema de Estímulos a la Banca] (SIEBAN) and guarantees issued by FIRA. One of the reasons for this is private bankers' belief that the continuing implementation of the free trade agreement and the associated market liberalization process are generating an extremely high degree of uncertainty with regard to the sector's future and its ability to adapt to new market conditions.

### C. Other private financial intermediaries in rural areas

- 2.6 The association of savings and loan institutions, known as **Entidades de Ahorro y Crédito Popular** (EACPs), is formed by various types of organizations whose origins and histories reflect very special sorts of operational and other characteristics. These institutions serve middle- and low-income segments and include both regulated bodies, such as savings and loan associations and credit unions, and a large number of organizations that have not been regulated in the past and whose activities are still not supervised by the financial system's authorities. In order to regulate these institutions and facilitate the consolidation of the more successful operations while permitting an orderly withdrawal of those that are not financially viable, in 2001 the Savings and Popular Credit Law was enacted, and in September 2002 general rules were established to govern the EACPs' four operational levels and define the activities in which its members are authorized to engage.<sup>5</sup> This law provides for the rationalization of the various institutional structures now in existence through the establishment of two institutional frameworks: consumer-level financial institutions that operate as corporations, and savings and loan cooperatives, which work with social agencies.

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<sup>5</sup> The rules establish these levels based on the institutions' assets, number of members or clients, and regional coverage. The lowest is for institutions having assets totaling US\$30,000, fewer than 5,000 members, and local operations. Because there are so many institutions to be regulated and supervised, the relevant legislation provides for an auxiliary supervisory scheme to back up first-tier institutions, with responsibilities being delegated to the corresponding federations by the National Banking and Securities Commission [Comisión Nacional Bancaria y de Valores] (CNBV). Another noteworthy event has been the introduction of deposit insurance by an organization that is not backed by the government.

- 2.7 In order to backstop this reorganization effort, the decision was made to convert the National Savings Foundation<sup>6</sup> [Patronato del Ahorro Nacional] (PAHNAL) into the National Savings and Financial Services Bank [Banco del Ahorro Nacional y Servicios Financieros] (BANSEFI). BANSEFI is a national development banking and lending association whose main functions are to: (i) provide technological development, training, technical assistance, and financial services as a second-tier institution serving integration bodies and EACP members in order to help them adapt to the new legal framework; (ii) act as a financial agent for the federal government in the relevant negotiations; and (iii) backstop the National Banking and Securities Commission [Comisión Nacional Bancaria y de Valores] (CNBV) in the supervision of savings and loan federations and associations serving low- and middle-income sectors.
- 2.8 There are, in total, an estimated 680 intermediaries in Mexico that could qualify for conversion to a regulated status under the Savings and Popular Credit Law. For the most part, the available information on this type of intermediary is very limited, and this is particularly true of the intermediaries that serve rural areas. In order to have a more accurate picture of these institutions' performance, BANSEFI undertook a survey in 2001, with support from the World Bank, of 388 institutions; this sample included all the larger organizations of this type, so the survey was fairly representative.

**Table II-2**  
**Partial information on savings and loan institutions (EACPs)**  
**as of 30 June 2001**

Type of institution	Number of institutions	Number of members/clients (in thousands)	Total assets (US\$000)	Number of members or clients per institution	Institutions that compensate their directors
Savings and loan cooperatives	186	1,014	853,500	5,452	54
Savings and loan associations	7	640	536,100	91,429	4
Credit unions	24	38	212,800	1,583	11
Solidarity funds	129	142	83,700	1,101	5
Civil associations	18	116	105,900	6,444	6
Civil societies	5	1	1,100	200	1
Social solidarity societies	10	2	400	200	3
Other	9	134	46,100	14,889	2
<b>Total</b>	<b>388</b>	<b>2,087</b>	<b>1,839,600</b>	<b>5,379</b>	<b>86</b>

**Source:** IDB calculations based on data from the *Diagnóstico de la Situación Financiera, Equipamiento Tecnológico y Censo de las Entidades de Ahorro y Crédito Popular (EACP)*, BANSEFI, June 2002.

<sup>6</sup> The National Savings Foundation [Patronato del Ahorro Nacional] (PAN) is a public-sector agency created in 1949 to supplement the Mexican financial system. Its main function is to promote household saving. For many years, the PAN's efforts were confined to consolidating the excess liquidity of member intermediaries and paying out the returns from investments in federal government bonds.

- 2.9 While no detailed data are available on the size of these intermediaries' rural portfolios, it is known that 278 out of all such institutions (71.6%) report that they serve clients in rural settlements having populations of 25,000 persons or less. Of these 278 EACPs, 102 (36.7%) report they serve 100% of the rural population. Although the Savings and Popular Credit Law creates an appropriate framework for the development of urban and rural nonbank intermediaries, such institutions are still at a very early stage in their development. Private intermediaries' provision of financial services in rural areas continues to be quite uneven and insufficient. The vast majority of these intermediaries operate on a small and exclusively local scale, and many of them are not financially sustainable. As shown in Table I-4, professionalization in such institutions' management is still very limited.

#### **D. Obstacles to the expansion of private lending for rural areas**

- 2.10 The **administrative cost** of credit intermediation is higher in rural than in urban areas. These higher costs<sup>7</sup> are a consequence of the geographically scattered location of potential borrowers, the lower quality of roadway infrastructure in rural zones, and the seasonality of the rural economy. Because of the small scale of most rural production units, these higher costs have to be absorbed by the corresponding loans, which are generally smaller than the loans made in urban areas. Since very few lenders have so far created differentiated price structures to charge rural borrowers more than urban borrowers, these higher administrative costs—in combination with the smaller average size of rural loans and the fact that similar interest rates are charged for urban and rural areas—tend to make rural operations less profitable than urban transactions.
- 2.11 **Risk costs** also tend to be higher for rural credit because of the difficulty of diversifying the type of risk (weather, prices) characteristic of rural economies. This economic activity is also frequently approached from a political standpoint.<sup>8</sup> Private intermediaries' perception that providing credit to the rural sector entails higher levels of risk has been fueled by BANRURAL's poor loan recovery performance, the high delinquency rate for bank portfolios, and the emergence of a large debtors' movement in opposition to the repayment of credits in the second half of the 1990s. Nonetheless, international experiences demonstrate that it is possible for lenders to grant rural and agricultural credit, even on a small scale, while maintaining acceptable delinquency ratios. For example, Compartamos, a special-purpose

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<sup>7</sup> Lenders that serve small and medium-sized enterprises in both urban and rural areas report that their administrative costs are up to six percentage points higher in rural than in urban areas.

<sup>8</sup> In many countries, political circles and major social groups regard credit for rural areas as more of a development initiative than as a financial lending activity. This perspective has led to government intervention in these markets that has worked to the detriment of private service providers (through, for example, interest-rate caps; executive orders requiring intermediaries to reschedule or even write off loans that could otherwise have been recovered; or the provision of government credit on preferential terms and conditions).

financial institution (of the type known as SOFOLES) operating in rural areas of Mexico, reported an index of 1.13% as of 31 December 2001.<sup>9</sup>

- 2.12 The third factor involved in the limited volume of credit available to the rural sector is the **quality of rural loan collateral**. In many cases, the collateral provided for rural mortgages does not offer a sufficiently reliable option for loan recovery, especially in those areas where the demand for land is weak. This is true even in those countries where land mortgage collateral is easily constituted and executed. In Mexico, the **communal and ejido** forms of land ownership make it difficult for communal and ejido landowners to put up their land as loan collateral. These landowners are only able to offer a beneficial interest in the land as collateral, which is a right that creditors have great difficulty in exercising. Lending to ejido and communal landowners is hindered further by the requirement that the ejido and commune authorities' authorization must be obtained in order to issue a mortgage secured by property, which raises the parties' transaction costs. While the government is seeking to provide these producers with greater access to financing under the National Ejido Rights and Land Title Certification Program [Programa Nacional de Certificación de Derechos Ejidales y Solares Urbanos] (PROCEDE), which assists in obtaining title to ejido land and certified property rights, these segments continue to have less access to credit than private producers do.
- 2.13 With respect to the use of **interest-rate subsidies**, there are various government programs that subsidize lending to the rural sector. These kinds of programs have been in use for a long time in Mexico and account for a sizeable percentage of public expenditure in the sector.

## **E. Conclusion**

- 2.14 There are a number of major challenges that will have to be overcome in order to develop the supply of rural financial services by private intermediaries. Government plans and policies for this sector have been evolving towards a greater degree of private-sector participation in rural financing and have been focusing on resolving the main structural problems in the sector. International experience indicates, however, that although individual intermediaries may be successful in this area, their accomplishments are difficult to replicate. The development of private rural intermediaries is a painstaking, lengthy process which has no guarantee of success, even under the best of circumstances. State intervention aimed at increasing such ventures' chances of success is essential in order to help create the appropriate structural conditions and to encourage and, in some cases, supplement private enterprise. As has happened in the past in Mexico, government intervention may, however, displace and often deter such initiatives. A balance

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<sup>9</sup> As an introduction for the proposals set forth in this document, a summary is provided in section three of the main lessons learned from the promotion of this type of institution.

must therefore be struck between government programs and private enterprise in order to further this sector's future development.

### III. GOVERNMENT INTERVENTION IN RURAL FINANCIAL MARKETS

#### A. Financing for the rural sector and public expenditure

- 3.1 Historically, the State has been an important supplier of financing for rural areas in Mexico. This area of activity has, in fact, been identified as a primary focus of government action. The underlying assumption has been that the sector is not attractive to the private financial system and that government action in this area would help to galvanize the development of low-income segments of the agricultural sector.<sup>10</sup> Recently, as part of the steps being taken to reform the public sector's development banking system, the Government of Mexico has embarked upon an effort to scale back its role as a direct first-tier lender to all sectors and to begin focusing on the establishment of institutional schemes and incentives for promoting the emergence and development of private intermediaries.
- 3.2 The federal government is allocating considerable resources for use in strengthening the agricultural sector, facilitating structural changes in small-scale units that allow them to make the transition to other activities, and mitigating the effects of rural poverty.

**Table III-1**  
**Federal government expenditure on the**  
**agricultural sector and rural development**

Item	1990	2000	2001 (preliminary)	2002 (preliminary)
Federal government expenditure on the development of the agricultural sector / agricultural GDP	24.6%	14.6%	15.2%	16.9%

**Source:** Second report of the administration of President Vicente Fox.<sup>11</sup>

- 3.3 In 2002, the Secretariat of Agriculture, Livestock, Rural Development, Fisheries and Food [Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación] (SAGARPA) directed more than 55% of its resources to the PROCAMPO and Rural Alliance [Alianza para el Campo] programs. The PROCAMPO program was created for the purpose of compensating agricultural producers for their expected decrease in income as a consequence of the liberalization of agricultural markets and trade. The program was designed to last

<sup>10</sup> Historically, State involvement in providing finance for the rural sector has been so intensive that, in 1994, approximately 81% of all loans granted to ejido farmers were directly financed by State agencies such as the Social Development Secretariat's "Word of Honor" Credit Program (PROCREPA), which has a 63% share, and BANRURAL with a 15%.

<sup>11</sup> See <http://informe.presidencia.gob.mx/Informes/2002Fox2/website/cfm/index.cfm>.



15 years, ending in 2008. PROCAMPO contributes an estimated figure of approximately 8% of ejido owners' household incomes, but its contribution to the poorest households may be as high as 40%.

**Table III-2**  
**Resource inputs from PROCAMPO and number of producers**

	<b>Funding approved (millions of pesos)</b>	<b>Producers served (thousands)</b>
2000	10,379	2,681
2001	11,004	2,695
2002 (projected)	12,420	2,800

**Source:** Second report of the administration of President Vicente Fox.<sup>12</sup>

- 3.4 PROCAMPO subsidies are provided directly to participating producers based on the number of hectares they plant or the number of stock in their herds. In the past, PROCAMPO resources were issued after planting had been completed; this situation led to the emergence of a credit market for the prefinancing of these subsidies by banks able to draw upon the resources of the FIRA agricultural trust funds [Fideicomisos Instituidos en Relación con la Agricultura] (FIRAs), whose coverage expanded to as many as 459,010 producers in 1999.<sup>13</sup> In order to reduce the cost of these prefinancing arrangements for producers, in 2001 the system was modified to permit the issuance of these subsidies in advance. The program was also altered so that future resource flows from PROCAMPO can be used as guarantees for financial operations.
- 3.5 The Rural Alliance program (now known as the Alianza Contigo partnership program) started up in 1995. This program, which is designed to have a more specific type of direct impact on production than PROCAMPO, includes a series of subprograms focusing on the development of agriculture and livestock activities, market development, and rural development. Its objective is to foster technology transfer and to promote rural infrastructure and investment as a way of boosting activity in the sector. Both the federal and state governments fund this program.

<sup>12</sup> See <http://informe.presidencia.gob.mx/Informes/2002Fox2/website/cfm/index.cfm>.

<sup>13</sup> Data published in "Mercados e instituciones financieras rurales," Muñoz Rodríguez, Manrubio et al, Chapingo 2002.

**Table III-3**  
**Rural alliance**

	<b>Federal resources (millions of pesos)</b>	<b>State resources (millions of pesos)</b>	<b>Producers served (thousands)</b>
2000	3,285	1,452	4,439
2001	4,622	1,691	4,536
2002 (projected)	7,098	1,566	4,325

**Source:** Second report of the administration of President Vicente Fox.<sup>14</sup>

- 3.6 In addition to these programs, many other initiatives are being undertaken to promote rural credit. The most prominent among them are FIRA and Financiera Rural. There are also other programs, however, that do not specifically target the rural sector but still have a major impact on it. For example, BANSEFI works with all the EACPs, including those located in rural areas. The Secretariat for Economic Affairs is also moving forward with the implementation of a microfinance program in both urban and rural areas. Table III-4 provides an overview of the main programs in place in the rural sector.

**Table III-4**  
**Government programs and institutions**  
**In Mexico's rural sector**

	<b>First-tier</b>	<b>Second-tier</b>
Savings	PATMIR, BANSEFI	BANSEFI
Credit	Financiera Rural, FONAES, PRONAFIM, PAPIR, PROMJEF, PFG, PROMIR, DICONSA, FIRCO, FEGA, FOMMUR, FAMPYME, FICP, PCD, FFMUR, PROFEMOR, PMS, FIFONAFE, PROFOR	Financiera Rural, PROCREPA, FIRA, NAFIN
Hedging	ASERCA, FIRCO	Agroasemex
Subsidies and guarantees	PROCAMPO, FEGA, Oportunidades, PROCREPA, Alianza Contigo, PET, POP, FONAES, PROMIR, LICONSA PRONJAG, PSS, PROED, PIC3X1	FONAES, SIEBAN, SIECA, SEISUC

<sup>14</sup> See <http://informe.presidencia.gob.mx/Informes/2002Fox2/website/cfm/index.cfm>.

	<b>First-tier</b>	<b>Second-tier</b>
Technical services	PATMIR, CONALEP, INEA, PROBECAT, CONOCER, PEA, PROIJ, PIDL, CMC, CIMO, RENDRUS, INCA	BANSEFI, FIRA

\* The full names and main features of these programs are presented in the project's technical files.

## **B. The FIRA agricultural trust fund (FIRA)**

- 3.7 The FIRA program is composed of four trust funds which are administered by the Banco de México and work in coordination with one another to increase the supply of financial services, guarantees, training, and technical assistance for the rural sector. The services provided by FIRA include rediscounting of agricultural credit portfolios, loan guarantee services, and an assortment of subsidies and incentives for both participating intermediaries and end borrowers.

**Table III-5**  
**Comparison of FIRA and BANRURAL**

	<b>FIRA (September 2002)</b>	<b>BANRURAL (June 2002)</b>
Number of clients	1.5 million	700,000
Assets	MX\$112 billion	MX\$38 billion
Portfolio	MX\$24 billion	MX\$15 billion

**Source:** CNBV, SHCP, and BANRURAL.

- 3.8 FIRA rediscounted 1,412,000 credits in 2001, for a total volume of US\$2.666 billion. Primary production credits amounted to US\$1.685 billion, industrialization loans to US\$583 million, and those granted to commerce and service activities to US\$398 million. When broken down by branch of activity, FIRA channeled US\$1.702 billion to farming; US\$575 million to livestock activities; US\$47 million to forestry, US\$135 million to fisheries, and US\$207 million to other rural activities. This last category refers to financing provided for non-agricultural production activities in population clusters having fewer than 50,000 inhabitants; activity in this area has been very dynamic in recent years, with the level of financing—provided to over 275,000 rural units—having increased by 117% over its 2000 level.<sup>15</sup>
- 3.9 FIRA does, however, have some difficulty in placing agricultural loans through the banking system. Consequently, as time has passed, other nonbank channels have been introduced into this area of activity. The volume of operations corresponding

<sup>15</sup> All data on FIRA activities have been taken from the FIRA activity report for 2001.

to each of the different channels is indicated in the following table in order to provide an overview of the various schemes in operation.

**Table III-6**  
**Channels for rediscounting FIRA credits**

<b>Channel for disbursement / administration</b>	<b>Amount disbursed (in millions of dollars)</b>	<b>Number of credits (in thousands)</b>	<b>Average amount of credits disbursed (in dollars)</b>
<b>Private banks:</b>			
Direct bank placements	1,469	259	5,672
Placements through parafinancial agents	403	216	1,866
Placements through PROCREPA agents <sup>16</sup>	181	105	1,724
<b>Subtotal, private banks</b>	<b>2,053</b>	<b>580</b>	<b>3,540</b>
<b>Credit unions</b>	96	101	950
<b>BANRURAL</b>	517	731	707
<b>Total</b>	<b>2,666</b>	<b>1,412</b>	<b>1,888</b>

**Source:** Original calculations, based on the FIRA activities report for 2001.

- 3.10 Intermediaries operating with FIRA funds receive a borrower-service subsidy for channeling credits to new, small-scale clients. These subsidization mechanisms are known as the Banking Incentive System [Sistema de Estímulo a la Banca] (SIEBAN) and the Credit Union Incentive System [Sistema de Estímulos a las Uniones de Crédito] (SIESUC). Banks receive 100% of the subsidy for a new client and, thereafter, 50% for up to three years (one operation per year). These subsidies totaled US\$43 million (7.6% of the amount of credit granted) in 2001, and helped 428,000 producers gain access to the system.<sup>17</sup> The FIRA program's operational outlays greatly exceed its revenues, and its capital is therefore shrinking year by year. The funding level is a fixed sum composed of a capital base and a credit from the Banco de México. If FIRA continues to use its existing operating model, it will have fewer resources available in the future and its level of operations will steadily decline.

<sup>16</sup> Managed Credit Program.

<sup>17</sup> SIEBAN subsidies are provided to banks both for the credits they channel to clients directly and for credit supplied to clients via para-financial institutions.

## C. Financiera Rural

### 1. The BANRURAL system

- 3.11 The BANRURAL system used to be composed of 12 regional banks and one central bank. When its coverage was at its height, during the 1980s, BANRURAL was serving nearly 1.5 million producers, or more than 60% of the agricultural producers in the country. As of the end of 2002, BANRURAL was serving nearly 154,000 borrowers as a first-tier institution, and these borrowers, in their turn, represented approximately 400,000 producers. These producers, most of whom were small and medium-scale farmers, received close to MX\$10 billion per year. In addition to providing credit services, BANRURAL took in deposits from the public through its branch banking network. However, leveraging of those deposits was confined mainly to short-term instruments in cities with populations over 50,000.

**Table III-7**  
**Consolidated financial statements of BANRURAL**  
**(in millions of current pesos)**

	12/31/1999	12/31/2000	12/31/2001
<b>Assets</b>		(Restated)	
Loans outstanding	25,538.3	10,836.4	9,155.1
Nonperforming loans	3,744.6	3,900.2	5,980.3
Less: credit risk	(2,680.6)	(2,918.3)	(2,997.2)
Net portfolio	26,602.3	11,818.4	12,138.2
<b>Total assets</b>	<b>34,897.0</b>	<b>34,839.3</b>	<b>33,216.3</b>
<b>Liabilities</b>			
Total deposits	18,083.4	21,100.0	22,283.2
Interbank loans	12,102.6	10,894.5	10,694.5
<b>Total liabilities</b>	<b>33,199.0</b>	<b>33,581.7</b>	<b>33,818.7</b>
<b>Total capital</b>	<b>1,698.0</b>	<b>1,257.5</b>	<b>(602.4)</b>
Revenues	5,718.7	5,543.8	3,773.7
Financial spread	1,218.5	2,313.0	629.1
Administrative costs	3,159.9	3,116.9	2,758.4
Net earnings	(37.5)	(180.4)	(1,137.9)

- 3.12 Since the early 1990s the institution has continually been faced with serious financial problems even though it has been capitalized on various occasions, with the last such case, which occurred in 1999, involving an injection of MX\$1.1 billion. BANRURAL's financial problems are structural in nature and arise out of an unsustainable operational cost base and an oversized organizational apparatus (BANRURAL had 30,000 employees at one point). One of the heaviest burdens in its cost structure is the liability generated by its nearly 9,000 pensioned former staff members. In 2002, operating costs amounted to MX\$3.062 billion, which means that it cost MX\$0.33 to place MX\$1.

- 3.13 Furthermore, the institution's credit practices and policies suffered from a number of shortcomings. As a result, nonperforming loans represented 48% of its total portfolio as of December 2002. BANRURAL sustained losses of MX\$7.77 billion during fiscal 2002. At the end of 2002 its asset position stood at an accumulated deficit of MX\$7.763 billion (US\$740 million). The institution is clearly unviable, particularly because of its operational weaknesses, the high labor costs occasioned by its pension payment commitments, and the poor quality of its portfolio.
- 3.14 BANRURAL was on the brink of serious distortions in the farm credit market. Its poor loan recovery rate and partial or total remissions of debts have had undesirable effects on payment discipline among borrowers. In addition, the interest rates were set in a way that did not reflect operating costs or the risk associated with operations.

## **2. Liquidation of BANRURAL**

- 3.15 Given the impossibility of continuing to finance BANRURAL's extremely high operating costs, the executive branch submitted a bill to Congress providing for the liquidation of BANRURAL and the establishment of Financiera Rural to take its place. Accordingly, in December 2002 Congress passed the Act Establishing Financiera Rural [Ley Orgánica de Financiera Rural] (LOFR), together with an additional budgetary allocation of MX\$48.878 billion (US\$4.655 billion). The LOFR called for the BANRURAL system to continue operating until 30 June 2003, and the newly established Financiera Rural to commence operations as of 1 July.
- 3.16 In all, MX\$31.363 billion of the additional budgetary allocation was to be used to liquidate BANRURAL, as follows: (i) MX\$15.682 billion to cover asset transfers, the liquidator's administrative costs, and the BANRURAL system's liabilities and losses; (ii) MX\$4.034 billion for payroll and for the employees' severance packages; and (iii) MX\$11.647 billion to cover retirement pension obligations and employees' vested rights to medical services. All these resources were transferred to BANRURAL and charged against the 2002 budget, thereby precluding future fiscal costs. A portion of BANRURAL's assets will be transferred to Financiera Rural (some real estate and moveable property, and nearly MX\$5.89 billion in current portfolio and cash). The remainder will be transferred to the Asset Management and Disposal Service [Servicio de Administración y Enajenación de Bienes] (SEA), which is responsible for liquidating the various components of the BANRURAL system. The Secretariat of Finance and Public Credit [Secretaría de Hacienda y Crédito Público] (SHCP) has dictated the manner in which the liquidation process is to be carried out. BANRURAL deposits that have not been withdrawn by account holders (the majority) have been transferred to other intermediaries, particularly BANSEFI. The possibility of the Bank monitoring the process of recovering the roughly US\$850 million to be transferred to SEA was explored with the authorities. However, the portfolio consists mainly of undocumented or poorly documented loans. The majority are small loans spread

over the entire country, which makes their collection a costly and drawn out process, especially for loans to individuals. For these reasons, there was very little likelihood of achieving a significant recovery rate. In addition, Financiera Rural has adopted a policy of not making any loans to those with outstanding debts to BANRURAL. This policy will protect Financiera Rural's own loan portfolio and create incentives for delinquent borrowers to bring their accounts current.

### 3. Founding of Financiera Rural

- 3.17 In order to prevent a repetition of the major errors that led to the liquidation of BANRURAL, Financiera Rural has been given a number of features that differentiate it from its predecessor: (i) It has been structured as a development agency whose only source of funding is the allocations approved by Congress, and therefore has no possibility of leveraging its capital by taking in deposits from the public or borrowing from other financial institutions (for a long time, BANRURAL covered its losses by borrowing on the markets); (ii) In terms of its management structure, Financiera Rural reports to the executive branch, but its budget and financing are the responsibility of the legislature, to which it is accountable for the use of those funds. In other instances, this governance structure has proved effective in preventing political decisions from supplanting technical considerations in the management of the organization; (iii) Financiera Rural's terms of reference require it to provide credit on a sustainable basis, which means that, at the least, it must maintain its assets at a constant level in real terms; (iv) Although Financiera Rural has been instructed, on a temporary basis, to serve directly (as a first-tier lender) the credit needs of small and medium-scale farmers, its medium-term objective is to encourage the private sector to furnish financial services to these sectors via second-tier operations and to provide training and technical assistance; (v) Because it does not take in deposits from the public, the scope of its network of branch offices and the size of each branch are smaller, which has a direct impact on its operating costs; and (vi) The LOFR requires Financiera Rural to diversify its risk by limiting its exposure not only to individual borrowers or groups of related borrowers, but also to each individual market segment.

**Table III-8**  
**Profiles of BANRURAL and Financiera Rural**

	<b>BANRURAL</b>	<b>Financiera Rural</b>
Employees	3,500	1,149
Branches	205	99
First tier	Yes	Yes
Second tier	No	Yes
Deposits/borrowing	Yes	No
FIRA funds	Yes	No
Customer-based interest-rate subsidies	Yes	Interest rate covers costs

	<b>BANRURAL</b>	<b>Financiera Rural</b>
Scope of activity	Almost entirely in the agricultural sector	All rural sectors
Average size of loans to group	MX\$10,000	MX\$20,000-70,000
Average size of loans to individuals	MX\$6,400	MX\$2,000-20,000

- 3.18 Of the MX\$41.878 billion approved by Congress, MX\$17.515 billion have been allocated for the establishment of Financiera Rural. Of this sum, MX\$6.571 billion correspond to the transfer of cash and the viable loans in BANRURAL's portfolio and its assets to Financiera Rural, while the remaining MX\$10.944 billion are liquid assets. Of this latter amount, MX\$9.644 billion may be placed as loans, MX\$800 million may be used to cover administrative costs, and the remaining MX\$500 million to provide training to borrowers and rural financial intermediaries. The CNBV will supervise the institution's compliance with the prudential regulations applicable to development banks. The SHCP will be in charge of approving its portfolio rating provisioning system. The SHCP will also be responsible for approving the operating budget.

#### **4. The Financiera Rural strategy**

- 3.19 **Financiera Rural's objectives** are to support the State's efforts to promote development of agricultural activities through the provision of credit on a sustainable basis, and to help improve the Mexican financial sector's services to the rural sector. To this end, it may engage in all types of financial operations, including the issuance of guarantees, factoring, and hedging. It may not, however, take in public resources of any sort, and it is prohibited from administering trust funds that draw on public resources. Lending decisions for credits of up to 700,000 UDIs (US\$20,000), which will account for the vast majority of the institution's lending operations, will be taken on a decentralized basis by the regional coordination offices under guidelines approved by the Governing Council.
- 3.20 As noted earlier, Financiera Rural's **governance structure** differs from BANRURAL's in that it provides for dual oversight of the institution's financial operations by the executive branch and Congress. In addition, Financiera Rural is subject to the regulations governing the development banking system. A major change was made in these regulations in mid-2002 as part of the amendment of the Financial Institutions Act. One of the amendment's aims is to provide the management of these institutions with more flexibility and independence in such areas as decision-making with regard to the budgeting of expenditures, investments, and borrowings. The regulations also set new standards for transparency and define management's responsibilities in terms of operational outcomes. In addition, all such institutions are required to set up a comprehensive risk committee to advise their governing councils as to what steps need to be taken to limit and diversify the risk associated with their operations. The governing councils are also to have



independent members, as a means of enhancing transparency in the management of these institutions.

- 3.21 Financiera Rural's **target market** is composed of small and medium-scale agricultural producers and all other individuals or entities in the rural sector. This market can be served either directly or via rural financial intermediaries. It will also provide credit through the various partnership arrangements that are widely used in rural areas (parafinancial agents, rural producer associations, and others). Six regional coordination offices have been set up to serve this market. Depending on the operational zone concerned, up to 99 branches and approximately 35 modules (small, temporary outlets) will report to these offices. When the targeted level of operations is reached, there will be a maximum of 1,149 employees. Whenever possible, the use of cash in these branches and modules will be avoided in order to reduce operating and security costs. Existing networks of financial intermediaries, particularly the BANSEFI network and associated institutions, and the issuance of credit cards will be used as vehicles for the movement of resources.
- 3.22 It was agreed that, during the first year that the new institution is in operation, the **expansion of credit** for borrowers in good standing would be limited to 10% above the level granted by BANRURAL in the second half of 2002. Lending during the first semester of operation is not to exceed MX\$5 billion, to be distributed among nearly 45,000 borrowers. No borrower who has debts outstanding with BANRURAL may obtain resources from Financiera Rural. To this end, an internal credit bureau that maintains records on the credit histories of BANRURAL customers has been created. In the past, efforts to integrate that bureau with Mexico's general credit bureau have failed because of the opposition from borrowers' associations and the size of the individual loans involved. One of the objectives that the current management has set for itself, however, is to achieve that integration in the near future.
- 3.23 The IDB's team has worked in close coordination with the Financiera Rural's technical staff to generate financial projections. Table III-9 provides an overview of the results. One of the main issues that had to be resolved in order to calculate these projections was the level of the interest rates to be charged for Financiera Rural's products. The general policy approved by the Governing Council is that the rates for first- and second-tier operations should be set with a view to maintaining the institution's financial stability. In calculating the rates for all the various lending products of the institution, the following components will be taken into account: (i) the cost of capital (inflation rate); (ii) operating and administrative costs; and (iii) spreads calculated on the basis of the risk associated with projected loan losses. Projections indicate that, in order to meet all these conditions, the average spread should not be less than 8%. By the same token, the different scenarios demonstrate how sensitive the results are to the expected loan-loss ratio for these operations, much more than to such other variables as operating costs and the cost of funds. It therefore comes as no surprise that, as the figures indicate, the future of this

institution will be determined by its loan recovery capacity. The **interest rate structure** recently approved by Financiera Rural's Governing Council calls for risk margins of 3% to 20%. For an estimated operating cost of 4.5%, these margins initially would fall between 7.5% and 24.5% depending on the level of risk associated with the operation. Financial projections show that the margins are wide enough to cover all operating costs plus the imputed costs of capital and credit reserves, and so ensure the institution's financial viability. While the rate used to determine the cost of capital (inflation) is not representative of market conditions, this rate structure will substantially reduce the market distortion created by BANRURAL's operations.

**Table III-9**  
**Financial projections for Financiera Rural, 2004-2008<sup>18</sup>**  
**(in millions of pesos)**

	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Investment	6,947.5	6,145.5	5,323.5	4,699.6	4,080.0
Loans outstanding: first tier	7,524.0	8,369.4	8,630.9	9,494.0	9,747.2
Loans outstanding: second tier	1,881.0	2,092.3	2,877.0	3,164.7	4,177.4
Nonperforming loans	495.0	550.6	605.7	666.2	732.9
Allowance for bad debts	(469.3)	(633.9)	(807.6)	(987.2)	(1,170.8)
Total assets	17,072.3	17,194.2	17,244.3	17,605.8	18,091.7
Total revenues	1,252.7	1,460.5	1,660.0	1,921.0	2,156.9
Gross financial spread	934.7	1,252.0	1,475.7	1,761.3	2,015.9
Loan-loss provisioning	(545.6)	(705.2)	(779.4)	(845.8)	(916.5)
Current expenditure	(834.0)	(800.0)	(824.0)	(848.7)	(874.2)
Net earnings	138.2	118.9	210.3	359.5	483.7
Average interest	13.3%	14.0%	14.4%	15.2%	15.5%

3.24 Given the lack of a broad network of rural financial intermediaries, the **transition to second-tier operations** will be gradual. On the other hand, it is clear that the use of such intermediaries is the only way in which Financiera Rural will be able to expand its coverage at a reasonable cost. The management decision to limit the number of Financiera Rural's employees and direct sales points attests to its desire to initiate this process as soon as possible. However, because the network of rural intermediaries is so thin, this process entails a certain amount of risk and therefore calls for a prudent, gradual approach. Financiera Rural has set itself the goal of having second-tier operations account for at least 25% of its lending volume by

<sup>18</sup> The explicit cost of capital is equal to inflation.

2006. Its chances of reaching this goal will not depend entirely on its own programs, but will also be influenced by the development of the financial system in general and by how much progress can be made in enhancing the technical qualifications and solvency of rural intermediaries.

- 3.25 **Other government measures.** The government has recently introduced a series of measures aimed at facilitating the flow of information and reinforcing creditors' rights. In January 2000, a law was passed that regulates the operation of credit bureaus as privately-owned entities. The Buró de Crédito focuses on developing information systems capable of providing financial intermediaries with complete, reliable, up-to-date credit histories of prospective customers. To date, the information compiled by the Buró de Crédito is still incomplete in some areas (e.g., information on small loans is lacking, especially in the rural sector). Access costs are also still quite high because not all institutions make use of this service.
- 3.26 With respect to **collateral or other forms of security for financial operations**, in 2000 legislation was passed which establishes legal procedures for the provision of collateral without right of conveyance and for the holding of collateral in trust. These contracts supplement the existing array of differing types of personal and real property that may be used as collateral and introduce innovative mechanisms for extrajudicial claims enforcement. Financial intermediaries' use of these procedures has been limited, however, because they both involve an increased level of risk for intermediaries, since if a guarantee is executed via the sale of the good or goods used as collateral without conveyance or as a guarantee in trust, the debtor's total credit obligation is extinguished, even if the proceeds from the sale do not cover the total amount of the debt. In April 2003, Congress passed a further amendment that reduces the transactions costs of this system of guarantees by introducing nationwide changes designed to streamline and standardize legal processes, especially with regard to notification and lien filing, which fall within the jurisdiction of state courts (and are therefore heard by the state courts). The amendment also strengthens the procedures for holding loan security in trust, and particularly for extrajudicial claims enforcement, thereby expediting the recovery of collateral in the event of default. The Transparency and Competition in Guaranteed Lending Act [Ley de Transparencia y Fomento de la Competencia en el Crédito Garantizado] was also passed. Under this legislation, guarantees or security need not be re-established but may instead be subrogated to the buyer, in the event of a sale, or to the new creditor, if the obligation is being refinanced. This legislation is also intended to lower transaction costs occasioned by notarial registrations and operations.<sup>19</sup>

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<sup>19</sup> A MIF operation aimed at improving access to credit by strengthening property rights will finance three state-level projects designed to increase the quality, transparency, and efficiency of local title offices and the regulations governing them.

## D. Conclusions

- 3.27 Rural credit in Mexico is still at a very early stage of development. The factors hindering its further development can be divided into three categories:
- 3.28 **(i) Unprofitability of agricultural activities.** Producers who were quick to adapt to the changed conditions created by NAFTA and the reduction of government agricultural subsidies have found attractive business opportunities in export markets, especially for fruits and vegetables. A large percentage of rural producers have not, however, taken advantage of those opportunities and continue to produce traditional products that have very little potential under existing circumstances. As the trade liberalization proceeds as agreed upon for the next few years,<sup>20</sup> the foreseeable reduction in the prices for thus-far protected agricultural products will result in lower demand and higher risk.
- 3.29 **(ii) Absence of a network of first-tier intermediaries in the rural sector.** Although nonbank financial intermediaries are playing an increasingly important role, rural financial service markets are still highly segmented, lack depth, and have little penetration. There are a number of reasons why these conditions continue to exist and are, in fact, intensifying: (1) the geographic dispersion of users makes for high transaction costs; (2) the covariance of risk in rural activities makes it difficult to diversify the risk associated with lending operations; (3) it is difficult and expensive to obtain information (for example, information is not available from the Buró de Crédito on low-income producers' portfolios, especially within the ejido sector); (4) there are a number of factors that hinder the timely collection of loan payments and enforcement of claims on collateral; (5) there are large segments of producers and other rural clients whose loans are classified as nonperforming; and (6) as a consequence of past episodes of government intervention, there is a deeply rooted perception in the market that serving low- and middle-income producers is a high-risk venture.
- 3.30 **(iii) Diffuse, uncoordinated state intervention.** The government intervenes in rural credit markets in various ways, but these initiatives are not part of a coordinated strategy for assisting rural private financial institutions and they have not resulted in a sustained or sustainable expansion of the supply of financial services in rural areas. In most instances, government intervention has been aimed at boosting the supply of first- and second-tier credit services. These interventions have focused on maximizing the amount of funding being channeled to borrowers, and no special consideration has been given to how they might affect the development of local financial intermediaries. And, in fact, they have created adverse conditions for the expansion and consolidation of sustainable financial intermediaries. BANRURAL and FIRA have been the main vehicles for these

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<sup>20</sup> Factors contributing to this reduction include both the greater productivity of Mexico's trading partners and the sizeable subsidies that these countries provide to agricultural producers.

interventions. As discussed above, BANRURAL has had to be liquidated because of its untenable financial and institutional situation. FIRA, for its part, is having increasing difficulties in channeling resources through the banking system, and it also needs to adapt its products to meet the needs of small-scale producers.

- 3.31 The proposed program will seek to backstop a series of measures designed to make government intervention more efficient. These measures have objectives that are limited in scope; their aim is not to solve the sector's problems outright but rather to create more favorable conditions for the provision of financial services in rural areas. The government has already taken a number of important steps in this direction, including the enactment of the Savings and Popular Credit Law, the amendment of regulations governing the rights of creditors and the recovery of collateral, reforms in the governance structure of financial institutions, the regulation of credit bureaus, and the introduction of provisions concerning the diversification of intermediaries' risk. The measures proposed in the program for addressing significant aspects of government policy on rural financial intermediation would complement those efforts and be a major step forward in the process of applying market principles for better rural credit market operation.

## **IV. DESCRIPTION OF THE PROGRAM**

### **A. Program objectives**

- 4.1 The program's objective is to expand and consolidate the supply of financial services for rural sectors. This expansion effort involves various elements. One is to increase the number of users of credit, savings, and hedging services in rural areas. Another is to increase the amount of resources being intermediated by the various public and private bank and nonbank institutions and to achieve a moderate increase in the number of private intermediaries serving this sector.
- 4.2 The specific objectives are: (i) to increase the efficiency of the government's instruments for working with the rural sector by liquidating the National Rural Credit Bank [Banco Nacional de Crédito Rural SNC (BANRURAL)] system and establishing Financiera Rural, as well as tighten coordination among the various government programs; and (ii) to improve the conditions for the development of bank and nonbank financial intermediaries in rural areas.

### **B. Structure of the operation**

- 4.3 The IDB would backstop this process by furnishing a US\$300 million policy reform loan divided into two equal tranches to be disbursed over a period of no less than 18 months. In order to meet the objectives outlined above, the program has been divided into two components: (i) implementation of measures for increasing coordination among the various government programs in the sector; and (ii) liquidation of the BANRURAL system and the establishment of Financiera Rural.

### **C. Planned program actions**

#### **1. Actions completed prior to submission to the Board of Executive Directors**

- 4.4 Prior to submission of this operation to the IDB Board of Executive Directors for consideration, the following had occurred:
  - (a) The Act Establishing Financiera Rural [Ley Orgánica de Financiera Rural] (LOFR) as a decentralized agency of the federal government and separate legal entity with its own assets, operating in the same sector as the Secretariat of Finance and Public Credit, entered into force on 27 December 2002.
  - (b) The decree amending and supplementing article 2 of the 2002 Federal Revenue Law [Ley de Ingresos de la Federación] entered into force on 27 December 2002. It authorizes the federal executive branch to obtain, use, and authorize

credits, borrowings and other forms of public debt under the General Law on Public Debt [Ley General de Deuda Pública] to fund up to MX\$48.878 billion for the dissolution and liquidation of the BANRURAL system and establishment of Financiera Rural, as part of the 2002 Federal Expenditure Budget [Presupuesto de Egresos].

- (c) Financiera Rural possesses an institutional plan describing its mission, objectives, target market, principal instruments to promote credit and technical cooperation, coverage and number of branches, and its 2003 lending plan.
- (d) The following Financiera Rural instruments are in effect: (i) operating and lending permits; (ii) regulations governing the establishment, control, and distribution of Financiera Rural regional coordination offices and branches; and (iii) its charter.

## **2. Conditions precedent to disbursement of tranches**

- 4.5 **Macroeconomic stability.** The borrower will ensure that its macroeconomic policy remains aligned with the program's objectives. The government's program is described in the policy letter attached as Annex I.

### **a. Component I. Implementation of measures for increasing coordination among the various government programs in the sector.**

- 4.6 Coordination needs to be improved among the different agencies that provide credit services and assistance in the rural sector. At present, duplications prevent optimal utilization of government resources. Closer coordination is vital in order to limit subsidies, align the various programs' objectives and mechanisms, and prevent intermediaries and beneficiaries from engaging in arbitrage among the different programs. The authorities have already taken several important steps in this direction by eliminating the interest rate caps set by the FIRA agricultural trust fund [Fideicomiso Instituido en Relación con la Agricultura] for intermediaries under its financing program for low-income producers. To keep that process moving, the government has set up a high-level working group of SHCP-coordinated rural financial services institutions, including Financiera Rural, FIRA, and others, to coordinate actions to promote the establishment and strengthening of rural financial intermediaries.
- 4.7 The working group is expected to develop recommendations and build consensus as a way of giving current and future rural private intermediaries a sense of certainty and lessening disincentives to their startup and expansion. The Bank has been invited to participate in these meetings as an observer. Prior to disbursement of the second tranche, steps will be taken to gauge progress toward the working group's goal and verify that a strategy is in place for addressing any outstanding points.

## **b. Component II. Reform of the BANRURAL system**

- 4.8 **Strategic plan.** A strategic plan for the founding of Financiera Rural will be prepared and submitted to the Bank for its consideration prior to disbursement of the first tranche. The plan, which will have been approved by the Governing Council, will provide a detailed outline of the institution's financial objectives, customers, and products and will be accompanied by detailed financial projections for the next five years. This plan should cover: (i) design of risk assessment and management systems; (ii) design of management information systems; (iii) actions and targets for promoting the development of rural nonbank financial intermediaries; (iv) design of second-tier banking activities, including the timeframe for transition to second-tier operations and their structure, with procedures for lessening conflicts of interest between first and second tier; (v) guidelines for a staff incentive policy to encourage prudent lending decisions and loan recovery; (vi) organizational and budgetary separation of technical assistance services from Financiera Rural's other operations; and (vii) how environmental issues are to be addressed.
- 4.9 As conditions precedent to disbursement of the second tranche, it must be demonstrated that the actions set out in the strategy have been implemented and that, in particular, the following steps have been taken: (i) the number of branches has been kept below 100; (ii) Financiera Rural's credit package has been evaluated by an independent consultant under terms of reference agreed with the Bank; (iii) the planned management information system has been put in place and enables Financiera Rural to closely monitor the costs and profitability of credit operations, investments, branch offices, and lending and technical assistance programs; (iv) actions to promote the development of rural nonbank financial intermediaries have taken place as planned, including implementation of a training program for rural financial intermediaries; (v) second-tier operations have begun as planned, including a structure for second-tier operations and implementation of the planned procedures for lessening conflicts of interest between first and second tier; (vi) the planned staff incentive schemes aimed at achieving prudent lending decisions and loan recovery within the agreed parameters are being applied; (vii) the budgetary and organizational separation of technical assistance services from Financiera Rural's other operations has taken place as planned; and (viii) environmental issues are being addressed as planned.
- 4.10 **Operations of Financiera Rural.** Financiera Rural will provide first-tier credit services on a temporary basis. The precedent set by BANRURAL in rural credit markets means that Financiera Rural must operate properly from day one. It has been agreed, therefore, that prior to disbursement of the first tranche Financiera Rural will provide evidence of the following: (i) the risk assessment and credit areas have been set up with the necessary staffing, technology, authority, and independence to perform their functions; (ii) the lending manual for first-tier operations is in use; (iii) risk models are in place; and (iv) the institution is in



compliance with all applicable regulations, especially those governing accounting records, portfolio ratings, loan loss provisioning, and risk management systems and procedures. Since Financiera Rural is in the process of being established, it has been agreed that during the second half of 2003 the growth of its loan portfolio will be maintained at a conservative 10% or less of the credit granted by BANRURAL in the second half of 2002. Risk concentration and loan size will also be capped, such that the average loan size does not exceed 120,000 UDIs. The interest rates Financiera Rural charges on loans must both ensure its financial stability and foster development of rural intermediaries.

- 4.11 For disbursement of the second tranche, it must be determined that lending operations are being conducted in accordance with the first-tier lending manual and a second-tier lending manual has been approved and is in use. The interest-rate policy applied by the institution must also ensure its financial sustainability and be conducive to the development of rural private intermediaries. It must also be determined whether Financiera Rural is applying a policy to maintain net earnings at or above zero. Such revenues will be understood to include allotments and transfers approved by Congress and income from the interest and commissions charged for loan and investment portfolios. The imputed cost of capital (at least the inflation rate), operating expenditures, and the provisions set aside to cover the portfolio will then be deducted from those revenues. Budgetary transfers to Financiera Rural will be handled in a transparent manner and will initially be used to cover the costs involved in setting up Financiera Rural and to compensate it for the costs incurred in connection with programs implemented for other institutions.
- 4.12 **Establishment of first-tier intermediaries.** Financial service development models are to be designed so as to facilitate the creation and growth of sustainable intermediaries and an adequate supply of credit services for the various segments of the market. These activities will have to be adapted to the circumstances existing in each state or region in order to maximize their chances of success. The program will seek to arrive at agreements with some states that may wish to use these models, supporting their implementation of such agreements. A MIF project is being prepared to support this process.
- 4.13 As a condition precedent to disbursement of the first tranche, it must be determined that Financiera Rural has agreed with the Bank on a program to establish development models for financial intermediaries meeting the needs of the rural population, especially low- and middle-income producers. For disbursement of the second tranche, it must be determined that Financiera Rural has set up pilot programs in at least two states to establish and/or strengthen financial intermediaries meeting the needs of the rural population, especially low- and middle-income producers.

**D. Program strategy**

- 4.14 The Bank's loan program with Mexico as approved by the Board of Executive Directors provides for a loan to support the reform of the financial sector. At the outset of the preparatory process, the Government of Mexico requested that the Bank focus this operation on rural credit in order to support the formulation and implementation of a series of reforms aimed at promoting the development of rural financial markets. The operation described herein is intended to respond to that request by providing a policy reform loan for Mexico's rural financial markets.
- 4.15 In terms of general policy, the aim is to engender a process that will help set out the objectives of government intervention in rural finance. This will ensure greater consistency among the activities of the various programs by helping to align their work and public spending in the sector with the objectives of eliminating distortions in the medium term and promoting the establishment and development of sustainable financial intermediaries. The essential aim of these actions will be to achieve greater consistency among existing subsidies, particularly in terms of the cost of the government resources available for rural sector financing and the requirements that intermediaries must meet in order to be eligible for those resources. Various government agencies and programs provide financial and technical resources for the establishment and development of rural intermediaries. It is important to harmonize these programs' objectives more fully and improve the coordination of the agencies responsible for their implementation in order to increase the efficiency of government action in this area and to further the development of private intermediaries.
- 4.16 With regard to the instruments for government action in the sector, the program supports the reform of BANRURAL, which has been one of the instruments for intervention in rural financial markets that has had the most impact on small and medium-scale agricultural producers. Apart from the extremely high fiscal cost of repeated capital infusions required by that institution, its poor performance was a major source of market distortions, and its lax collections policy led to a progressive relaxation of payment discipline on the part of borrowers. Its disappearance and the creation of Financiera Rural are a very important step toward rectifying the negative impacts of government intervention in the sector.
- 4.17 The authorities are well aware that the government cannot and should not take the place of private rural financial intermediaries. Nonetheless, it is clear that at present there is no network of private intermediaries in Mexico that could perform the same function as BANRURAL. The government's efforts notwithstanding, the emergence and development of such networks is a lengthy process even under the best of conditions. The government's abandonment of the role it currently plays as a supplier of first-tier financial services is not a viable option in either practical or political terms at this point in time. The program has taken the potentially negative effects of government action on these private intermediaries into consideration and

has provided for means of limiting those effects. The most important tool to be used for this purpose will be the interest rates charged by Financiera Rural, which are to be set at levels that will cover its costs.

- 4.18 The program will include activities directed toward defining possible development models for private, first-tier financial intermediaries for rural areas. These activities will focus on compiling information on the best practices available and implementing them in two or three specific cases. Such intermediaries must cope with conditions and difficulties that have no easy solution. Conditions also vary a great deal from one state to another and even from one region to another. The development models will take into account not only the internal conditions that should exist in such intermediaries in order to increase their chances of success, but also the external conditions and possible government actions at the federal and subnational levels that would foster their development.
- 4.19 The above activities make for a consistent program that can build upon the regulatory framework that the government already has in place for the financial sector, in general, and nonbank financial intermediaries, in particular, in order to create conditions that are more conducive to the development of rural financial services.

#### **E. Prior experience and key lessons learned**

- 4.20 With the exception of some efforts to support specific intermediaries, the Bank has relatively little recent experience in working with rural credit markets. Generally speaking, multilateral agencies' experiences in promoting the expansion of rural credit have not been very positive. Government intervention via state-owned, first-tier financial intermediaries has had particularly negative results. Government policies in support of small and medium-sized agricultural producers have, in most countries, entailed large-scale intervention in the form of direct subsidization (support prices, production subsidies, etc.) and government intervention in financial markets via guarantees and interest-rate subsidies. As a consequence of the characteristic traits of this sector—such as risk covariance (or the difficulty of diversifying risk), the sparse distribution of borrowers, collection difficulties, the high degree of market segmentation, the lack or poor quality of collateral, the absence of reliable, timely information, and the costs associated with the scattered geographical location of beneficiaries—this activity is rife with difficulties, and international experiences include more failures than successes. Apart from microfinance institutions, there are few examples in the Latin American region of successful models for the provision of financial services in rural areas to small and medium-scale agricultural producers. There are significant cases in other countries, however, which demonstrate that, under suitable circumstances, public or private financial intermediaries can serve this market segment successfully. These success stories typically involve intermediaries that charge market rates, use modern

procedures for approving and monitoring individual loans, and keep their costs under control.

- 4.21 The emphasis currently being placed on primarily targeting credit for nonagricultural microenterprises (while excluding agricultural credits) for poverty reduction purposes does not address the entire scope of the problem in rural areas, since rural microenterprises rely heavily on local demand—and, hence, on income from agricultural activities—in order to remain viable. In most cases, these areas are not addressed by the financing provided to microenterprises. Specific complementary and additional action is therefore required in order to broaden the supply of financial services to include all segments of rural demand. Because of these factors, support for agricultural activities can have a significant impact on rural poverty.

**F. The program and the financial intermediation policy now under development**

- 4.22 The financial intermediation policy being developed by the Bank is based on the principle that financial markets must operate smoothly, if the financial sector is to allocate resources efficiently. The credit market in rural Mexico suffers from a number of major distortions and defects that keep it from operating smoothly. More than a few of these distortions stem from the government's sector policy. The authorities have begun making the adjustments necessary to eliminate these distortions. While the program does not aim to eliminate them all, it does take significant steps toward reducing them. It likely will take years to eliminate them all, and there likely will be advances and setbacks along the way, given the political implications of the rural sector in Mexico. The government's proposed solution addresses Financiera Rural's operating costs through a financing mechanism (essentially tax resources) and makes its operations more transparent. Compared to the situation with BANRURAL, Financiera Rural represents major progress toward reducing distortion in the rural credit market.
- 4.23 The policy proposal places specific emphasis on the difficulties faced by second-tier financial intermediaries in cases where prevailing circumstances have prevented first-tier private intermediaries from being successful. In instances where the idea is to provide direct assistance to first-tier intermediaries, it must be demonstrated that public intermediaries have certain advantages over private operators that will enable them to provide intermediation services on a sustainable basis. While the program includes no direct financing to Financiera Rural, several factors may have a positive impact on its development in the medium term: (i) Financiera Rural's national presence will permit it to diversify its portfolio risk and thus partially offset the problem posed by the covariance of credit risk; (ii) Financiera Rural has the capital to try out different technologies and see how they may be adapted to existing rural conditions, inasmuch as there are no instances of the successful application of credit technology in Mexico; and (iii) Decades of operating in Mexico's rural areas have

given BANRURAL a wealth of rural lending experience and know-how, on which Financiera Rural can build in structuring its operations; and (iv) Financiera Rural's interest rates must be at least high enough to cover its operating costs (including imputed costs of capital), and so ensure the institution's financial viability.

#### **G. The program and the rural financing strategy**

- 4.24 This program is consistent with the Bank's rural finance strategy<sup>21</sup> in supporting the establishment of a government financial institution that will engage in first-tier operations on a temporary basis only. The strategy allows the Bank to support government first-tier financial institutions under certain conditions, even when there are interest rate subsidies, provided there is a plan to eliminate them or at least transfer them to budgeted operations that can function with private banks. As explained earlier, private financial intermediaries are not yet in a position to adequately support the government's efforts to reach its rural development goals. This institution will gradually make the transition to second-tier operations and, to that end, will work to promote the development of a market for private financial intermediaries. The government has also agreed in its policy letter to phase out interest rate subsidies. The LOFR and Financiera Rural's own rules of procedure call for these subsidies, while still in place, to be financed by budgetary resources allocated by Congress for that purpose in a transparent manner.

#### **H. Rationale for Bank involvement and the program strategy**

- 4.25 **Country strategy.** Promoting the rural population's integration into the country's productive sector development is a priority for the Government of Mexico and complements its political and economic reforms. The 2001-2006 National Development Plan calls for the implementation of strategies for providing inhabitants of agricultural areas with access to the services furnished by financial institutions and thus to other production options that will provide them with new income-earning opportunities, thereby consolidating the country's integral agrarian development.
- 4.26 **The Bank's strategy.** The proposed program is consistent with the Bank's country strategy with Mexico as set forth in the relevant country paper (document GN-2181). Specifically, this paper discusses the need to continue the process of increasing the efficiency of the public developing banking system and ensure that the savings and loan associations that serve the poorer sectors of the population function better.
- 4.27 **Coordination with the World Bank.** The IDB team has been working closely with the World Bank's team, which received approval for a parallel operation for US\$505 million in June 2003. The World Bank program has a different, yet

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<sup>21</sup> *Rural Finance Strategy*, IDB/SDS, February 2002.

complementary, orientation, since it is mainly focused on issues involved in the reform of the overall development banking system. In that connection it does address some specific aspects of the reform of the BANRURAL system, especially in relation to the quality of the portfolio that is to be transferred to Financiera Rural. The World Bank operation has a conditionality very similar to the one in component II of this operation, but does not include the actions provided for by component I. The main difference is that the World Bank loan calls for three disbursements: the first for US\$200 million has been released, and two tranches of US\$150 million remain. The IDB loan disbursements are to coincide with these two pending tranches. This collaboration has permitted joint missions to be carried out and has facilitated dialogue between the two institutions and the relevant authorities.

- 4.28 **Poverty-targeting and social sector classification.** This operation does not qualify as a social equity enhancing project as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704). The program is, however, expected to have an effect on the quantity and quality of the supply of financial services in rural areas. The satisfactory development of rural financial markets may have a positive impact on rural economic development, particularly in agricultural activities, and, indirectly, in terms of poverty reduction. There is evidence that agricultural development promotes economic growth in general and has a significant effect on rural poverty. By contrast, economic growth in urban areas has a clearly discernible impact only on urban poverty, while its effects on rural poverty are less evident.
- 4.29 **Environmental impact.** This program will have no direct environmental impacts, since all its activities focus on institutional and legal reforms in the financial sector. Financiera Rural could, however, have some environmental impact, since it will be called upon to determine what types of activities can be financed. As part of the program, steps will therefore be taken to ensure that the environmental dimension is integrated into the design of Financiera Rural's products and strategy and in assessing the risk of its operations.
- 4.30 **Money laundering.** Mexico has a far-reaching law for the prevention of money laundering (Article 400 of the Criminal Code). The Office of the Deputy Director-General for Transaction Investigations/Financial Intelligence Unit of the SHCP has been working actively to help combat this crime, and the Financial Action Task Force (FATF) has recognized Mexico as a full member.

## **I. Cost and financing**

- 4.31 The policy reform operation proposed in this document would be supported by a US\$300 million loan. This loan would be disbursed in two tranches of US\$150 million each, with the second tranche to be disbursed no less than 18 months after the first.

## **V. PROGRAM EXECUTION**

### **A. Borrower, guarantor, and executing agency**

- 5.1 The borrower will be the United Mexican States. The program will be executed by the Secretariat of Finance and Public Credit [Secretaría de Hacienda y Crédito Público] (SHCP) and Financiera Rural. The preparation of project performance monitoring reports will be the responsibility of Nacional Financiera, SNC (NAFIN), pursuant to the agreement entered into between the borrower and NAFIN, enabling NAFIN to act as managing agent for the program. As a condition precedent to disbursement of the first tranche of the loan, this agreement must have been entered into and be in force.

### **B. Program execution and administration**

- 5.2 **Disbursement procedure.** The loan proceeds will be used to support the borrower's public finances and balance of payments, subject to the limitations of Bank policies. The procedures set forth in document GN-2001-2 for sector loan disbursements to support policy reform will be applied.
- 5.3 With respect to the disbursements, the borrower will agree to deposit the loan proceeds in the separate Special Accounts for the program. The borrower will also agree to maintain, either directly or through NAFIN, separate accounting records and a separate internal control structure with supporting documentation that will enable the Bank to conduct the audits described in the following paragraph and determine how the loan proceeds are used and whether the borrower has met its obligations under the prospective loan contract in relation to the use of funds.
- 5.4 **Audits.** The borrower will agree to submit, through NAFIN, within 90 days after being so requested by the Bank, a statement of account on each disbursement prepared by an independent external accounting firm acceptable to the Bank in accordance with the Bank's auditing standards.

### **C. Monitoring and evaluation**

- 5.5 Missions to monitor progress will be conducted by the Bank's project team, with technical support being provided by the Bank's Country Office in Mexico. The borrower will meet the Bank to exchange views on: (i) progress on program implementation and the fulfillment of policy conditions; and (ii) consistency between the macroeconomic policy of the United Mexican States and the program.
- 5.6 Prior to any such meetings, the borrower will provide the Bank with a report for review and comment, containing such information as the Bank may request. In the event that review of a report submitted by the borrower shows unsatisfactory

progress on program execution, the borrower will submit, within 30 days after being so notified by the Bank, reports or plans for measures to be implemented to bring program execution back into line, along with the relevant timeline.

- 5.7 The borrower has decided not to conduct the ex post evaluation of the program under Operations Policies Manual section OP-305. The borrower has, however, agreed to maintain and provide the Bank with such information as may be required to determine whether the program has met its objectives. To that end, it has been agreed that the borrower and/or executing agencies will report to the Bank twice a year on the performance indicators set in the following section. The borrower has also agreed to cooperate with the Bank on such evaluations as the Bank may conduct of this program.

#### **D. Performance indicators**

- 5.8 The following table shows the benchmarks to be used in evaluating the program's fulfillment of its objectives. These indicators are directly related to the primary and secondary objectives of this operation.

**Table V-1: Rural sector indicators**

<b>Line item</b>	<b>Average</b>	
	<b>2003</b>	<b>2008</b>
Average loan amount (thousand pesos)	485.2	789.4
Portfolio breakdown by amount:		
- Developing producers, level 1 (PD1)	33.9%	44.4%
- Developing producers, level 2 (PD2)	10.0%	10.5%
- Developing producers, level 3 (PD3)	56.1%	45.2%
Number of first-tier customers	114,980	154,320
First-tier total portfolio	7,233.0	11,482.7
Number of end customers through first-tier institutions	812,620	1,138,500
Number of first-tier institutions served	37	137
Second-tier total portfolio	28,888.1	51,668.2
Loans over 30 days past due (first tier)	15.8%	8.5%
Loans over 30 days past due (second tier)	0.4%	0.4%
Annualized portfolio charge-offs / average portfolio	2.1%	2.3%
Percentage of portfolio at rates with explicit subsidies	29.9%	10.9%
SDI index	90.9%	59.0%



## **VI. VIABILITY, BENEFITS, AND RISKS**

### **A. Viability of the program**

- 6.1 An open seminar on the future of BANRURAL was held with the participation of experts from the IDB and the World Bank in late 2002. The seminar was attended by campesino organizations, representatives of nonbank financial intermediaries, and a number of senators representing the major political parties. Various options for the development of rural credit were weighed. The participants came to the conclusion that BANRURAL had to be replaced by an efficient, financially sustainable intermediary. The political agreement reached on this point was a key factor in winning congressional approval of the Act Establishing Financiera Rural. The need for greater transparency and the importance of setting limits on the high fiscal costs of credit programs were central issues in the discussions and ultimately gave rise to the legal obligation of the institution's management to maintain the value of its capital in real terms and to report regularly to the executive branch and legislature on the results of its operations. In April 2003, following a complex dialogue marked by the mobilization of campesino organizations on a number of occasions, the National Rural Agreement [Acuerdo Nacional para el Campo] was signed. This document sets forth various aspects of the government's policies and plans concerning the rural sector, including rural financial services. The government made a commitment to institute reforms designed to lead to the creation of a nationwide finance system. This system will coordinate the various government credit programs with a view to creating a supply of competitively priced resources without jeopardizing the financial viability of these institutions.

### **B. Benefits**

- 6.2 The measures to be supported by this program have the potential to produce a significant social impact in the medium and long terms. Financial services need to be provided in a prudent, efficient manner in order to finance the sector's adaptation to the new conditions stemming from the free trade agreements in which the country participates, facilitate the expansion of production, and create more jobs in rural areas. At present, there are many different government programs focusing on rural financial services. These programs do not have shared objectives and, in many cases, are in outright competition with one another. Closer coordination among the various government programs could substantially increase the efficiency of public spending in this field and enable such programs to have a greater impact on rural areas.
- 6.3 The program will provide support for the transition from a financially unviable intermediary, which is extremely costly for the government and is having negative effects on the rural financial market, to a financial institution whose governance structure is conducive to organizational independence, is designed to reduce

political considerations' influence on decision-making and to promote the proper use of fiscal resources, and incorporates the job of safeguarding the development of financial markets as one of the institution's responsibilities. Financiera Rural will increase the supply of credit available to segments of the population traditionally unserved by private intermediaries. Clearly, no government institution with limited funding would be able to fully meet the demand for financial services of all five million economically active individuals residing in the rural areas of Mexico. This is why one of Financiera Rural's objectives will be to promote the development of a robust financial services market in the sector, and Congress has already allocated resources to it for this purpose. At a more general level, the repeated capitalizations of BANRURAL in the past absorbed a sizeable portion of federal budgetary resources. The efficient, financially sustainable operation of this agency will require no additional government resources and thus holds out the potential for ensuring that it will not, as has happened in the past, crowd out expenditure on very necessary programs, particularly in social areas.

## **C. Risks**

- 6.4 The process involved in founding the Financiera Rural is being pursued within the framework of a complex dialogue between the government and campesino organizations that feel that their interests are threatened by the forthcoming reduction in tariffs under the North American Free Trade Agreement (NAFTA). Concern about the future of the rural sector and, in particular, of the agricultural sector could end up exerting political pressure on Financiera Rural to disburse its funds rapidly. This could jeopardize the new institution's viability, since a rapid expansion of lending operations is very risky, especially for a newly founded organization. In order to mitigate this risk, it has been agreed that Financiera Rural is not to increase its lending operations by more than 10% above BANRURAL's lending level during the second half of 2003 with respect to the level granted by BANRURAL in the second half of 2002. In addition, in preparation for the second disbursement, its risk assessment systems will be analyzed by an independent consultant in order to determine whether these systems are adequate to manage the risk associated with an expansion of the institution's loan portfolio.
- 6.5 Direct government intervention in rural credit markets is a high-risk venture, and the results to date have not been very encouraging. The authorities expect that, initially, Financiera Rural will continue to provide first-tier credit services. There are two reasons for this: (i) as a result of the disappearance of BANRURAL, a considerable number of borrowers would otherwise be deprived of credit services (and experience shows that the emergence and development of private intermediaries is a slow process that calls for a great deal of backstopping, even in the absence of public lenders); and (ii) the issue of rural credit services has important political implications. A suspension of first-tier services, in the absence of a transitional solution, would not be politically viable. The governance structure of Financiera Rural, the independence of the lending process, training and

incentives for staff members, and the introduction of sophisticated risk models constitute the foundation upon which senior management expects to build a successful organization.

- 6.6 There is a risk that the government policy of subsidizing various programs' interest rates will limit Financiera Rural's ability to charge interest rates that will cover its costs. In addition, the continuation of those subsidies could crowd out private intermediaries. In its policy letter, the Government of Mexico has committed itself to reviewing interest-rate subsidies with a view to phasing them out. The government will also develop a strategy for coordinating the various programs that are now in place. This strategy will take into account the effects of these programs on the development of private intermediaries.
- 6.7 In the medium term, Financiera Rural will have a conflict of interest between the provision of credit services to the rural sector and the development of first-tier financial intermediaries. Its success or failure as an institution will largely depend on whether it resolves that conflict satisfactorily. Financiera Rural has committed itself to maintaining a budgetary and organizational separation of the areas responsible for second-tier operations. Financiera Rural's interest-rate policy should also be consistent with the objective of increasing private intermediaries' market share in rural areas.

**SUBSECRETARIA DE HACIENDA Y  
CREDITO PUBLICO**

**México, D.F. , 02 de octubre, 2003**

Mr. Enrique Iglesias  
President  
Inter-American Development Bank  
Washington D. C. 20577  
USA

Dear Mr. Iglesias,

This letter of Sector Development Policy describes the current Mexico's economic conditions and the ongoing effort of the Federal Government to reform the development banking system in an integrated way. The objective of this effort is to strengthen the public entities through a better focusing of their activities within the segments that they address, fostering the development of the private market and the financial viability and efficiency of their operations, while trying in the process to reduce the impact of public entities on public finances. With these efforts, the development banking system will be able to accomplish its mission of promoting national development through facilitating financial services to priority sectors and projects where the participation of the private sector is currently limited. One area in which the on-going efforts of the Federal Government to carry out financial sector reforms has been especially critical is the market for rural financial services. In this sector, our efforts aim to address the lack of credit in the rural areas of the country and to increase the participation of private credit agencies in the rural sector. The proposed reforms include i) reduce overlapping programs and avoid unintended effects such as the crowding out the development of private sector financial institutions and channeling resources away from the neediest producers; ii) liquidate Banco Nacional de Crédito Rural, S.N.C. ("Banrural"), iii) the creation of the Financiera Rural, and iv) supporting the training of private sector financial institutions targeting the rural sector. To carry out these reforms, and to reduce the associated fiscal costs, our Government requests the financial help of the Inter-American Development Bank.

**I. Macroeconomic Context**

After a period of rapid economic expansion during the 1997-2000, Mexico entered in a shallow recession that started in the last quarter of 2000 and culminated with a contraction of the Gross Domestic Product (GDP) of 0.3 percent in 2001. The economy started to recuperate in the second quarter of 2002, reaching a modest growth of 0.9 per

cent during the year. Both the recession and the recuperation reflect the level of growth of the US economy, Mexico's main trade partner. The economic program for 2003 include projected economic growth of GDP of 3 per cent, based on estimation of a moderate economic growth of the US economy.

Despite the recession, the monetary and fiscal policies have been focused on maintaining fiscal discipline, access to external markets, and inflation control. After a significant reduction of inflation and interest rates in mid-2001, the average inflation rate reached 5.7 per cent in 2002. Nevertheless, the monetary policy has been geared to reach larger reduction of inflation and recently has dropped to attain the target of 3 per cent in 2003. The inter-bank interest rate has recently moved in a range of 5 to 6 percent, which has resulted in a modest expansion of private sector credit, particularly consumer credit.

With respect to fiscal policy, our Government has followed policies to strengthen public sector solvency and to help maintain macroeconomic stability. Derived from this policy, fiscal deficit targets have been gradually reduced. Lower than expected revenues have been compensated with reductions in expenditures. Without considering the cost of liquidating Banrural, authorized by the Mexican Congress, the fiscal deficit has been kept within the original target for 2002 (0.65 percent of GDP). In terms of the broader Public Sector Borrowing Requirement deficit definition, the deficit has been slightly reduced from 3.0 per cent of GDP in 2001 to 2.6 percent in 2002.

The current account deficit during 2002 reached 2.1 per cent of GDP, compared with 2.9 percent in the previous year, despite lower exports to the US. This was in part due to the 52 per cent increase in the price of oil exports and the growth of remittances from Mexicans abroad, which surpassed tourism as a source of foreign exchange. On the other hand. On the other hand, direct foreign investment in 2002 kept similar levels as in 2001, not counting the effect of the extraordinary investment obtained by the purchase in 2001 of Banamex by Citibank (for US\$12 billion).

The evolution of the financial sector in the first half of 2003 responded to a series of international factors, including the uncertainty of the situation in the Middle East, the weakening of the world's major economies, and the market's nervousness in the face of possible terrorist activities.

## **II. Rural Finance Reform Program**

After completing the restructuring of the private banks following the 1994-1995 crisis, our Government is now committed to carry out the needed reforms of the development banking sector. This reform program has been focused on the restructuring of the development banks, strengthening their capacity to promote the financial markets in areas that are not adequately covered by the private sector. In this sense, their credit activities are now geared to second-tier lending through banks and non-bank financial intermediaries, with the emphasis on technical assistance. The subsidies that they provide are limited to those mandated by Mexican Congress and they have been induced to be focused and transparent.

Likewise, legal and regulatory reforms have been implemented to improve the governance and accountability of development banks and to put them under the same

prudential rules used for commercial banks. These reforms are also geared to promote the operational efficiency of these banks and to make them financially viable to limit their fiscal cost. For this reason, the following reforms of the legal and regulatory framework have been implemented:

- *Norms of portfolio classification and provisioning for credit institutions and development banks.* In October 2000, the regulatory authorities, particularly the CNBV, extended to development banks the norms for portfolio classification and provisioning that apply to private banks.
- In June 2002, the *Credit Institutions Law* was amended, together with the Charters of all the development banks (except Banrural) with the following objectives: improve governance practices; establish a system of agile and transparent accountability; modernize their managerial capability; strengthen prudential measures; as well as guarantee the financial sustainability of their operations.

The following legal and institutional reforms were also approved:

- *Law of Savings and Popular Credit (LACP) and Amendment to the General Law of Organizations and Auxiliary Credit Activities and to the General Law of Cooperatives.* In June 2001, the LACP was enacted and the amendments to the two mentioned laws, with the aim to stimulate public savings, particularly of small savers, and to regulate and supervise popular savings and loans institutions. In this way, the institutional basis to organize, regulate and promote the popular savings and loans sector were created. The LACP contemplates a limited time for the popular saving institutions to adjust their operations to fully comply with the law, or otherwise cease to operate. These reforms will contribute to complete the deepening of the Mexican financial system.
- *The Organic Law of the National Financial Services Bank (BANSEFI).* This law, also enacted in June 2001, establishes BANSEFI to promote savings and as a public entity in charge of providing services and complementary financial products to the popular savings and credit entities, to help them to channel these savings in an efficient and profitable manner to productive activities. It is appropriate to mention that BANSEFI will not be able to provide credit services.
- *The Organic Law for the National Mortgage Bank.* This Law, enacted in October 2001, creates an institution to promote the development of the mortgage market, which will be able to generate the resources to operate through the securitization of its portfolio, and promote the development of a secondary mortgage market through the granting of guarantees.

### ***Measures that will be taken to reorganize Government intervention in rural sector***

In order to reduce overlapping programs and avoid unintended effects such as crowding out the development of private sector financial institutions and channeling resources away from the most needy producers, we are committed to managing Government programs targeting the rural sector in an efficient manner to eliminate waste and reduce confusion among the recipient rural communities. In order to achieve this objective, the

Government will work to achieve a better coordination between the different Government programs in the rural sector.

In the same way, the activities of Financiera Rural will be complemented and fully coordinated with those of Fideicomisos Instituidos en Relación de Agricultura (FIRA.) This is particularly relevant during 2003, which will be a transition period for the Financiera Rural. It is important to reiterate that one of the mandates of the Financiera Rural is to be financially sustainable, and meeting this objective is subject to the evaluation of Congress, to which it must submit its results. In this sense, the interest rate policy will have to be congruent with this objective. On the other hand, FIRA's programs are being adjusted in order not to generate arbitrage problems in those segments where there are common clients. In addition, over the next few years, we also are moving towards ensuring that Government entities such as FIRA and Financiera Rural gradually set their interest rates to a level that will cover the appropriate risk margins for their portfolios, in order to charge interest rates closer to market interest rates.

### ***Measures taken to restructure Banrural***

With respect to the restructuring of the development banks, after having restructured the institutions in the housing and popular savings and loans mentioned before, the Government decided to focus in the task of solving the situation of Banrural, the public bank that has generated the largest fiscal losses in recent years. The strategy approved by Congress was to close Banrural and create, in its place, the Financiera Rural, a non-bank financial institution with direct funding from the national budget and operating with high efficiency and transparency.

The Charter of Financiera Rural (LOFR) was approved on December 27, 2002. In it, Congress authorizes the Federal Executive to transfer Ps31,363 million to Banrural with charge to the 2002 budget to carry out the process of liquidation. In the same way, Congress assigned Ps17,515 million as initial capital endowment of the Financiera Rural.

The mentioned law established a six-month transition period to start the liquidation of Banrural and initiate operations of the Financiera Rural. The liquidation process will be managed to maximize the recuperation of assets in liquidation and to provide incentives to minimize the fiscal costs to the Government. During the first semester of 2003, Banrural continued providing credits so as not to interrupt the flow of resources to the rural areas. At the same time, the public deposits managed by Banrural were transferred to other financial institutions.

The Financiera Rural has as mid-term objective to lend exclusively through non-bank financial intermediaries. In the short-term, while these intermediaries are being developed, it will be necessary that the institution act as credit provider to rural producers of low- and middle-income levels, to avoid a drop in credit to the sector. It is worth mentioning that from the start, Financiera Rural will support the creation and consolidation of non-bank financial intermediaries in the rural sector, for which task Congress assigned it Ps\$500 million as part of its initial capital.

According to the LOFR, another goal for the Financiera Rural is that it must be sustainable in the medium term. This implies that the net income is equal or greater than zero, which will be accomplished through maintaining efficient operating costs *vis-a-vis* the loan portfolio size and ensuring that portfolio losses are kept at a minimum. Also, and as a last resort, and in case it is necessary, in the short-term, the Government will contemplate supporting the operating costs of the Financiera Rural on a partial, transparent and temporal basis, in a way that the lending interest rates of Financiera Rural will always cover the funding costs and the risk of the operations. Care will be taken to prevent that the interest rates of the Financiera Rural produce market distortions.

### ***Measures taken to allow Financiera Rural to initiate its operations***

The Charter of Financiera Rural establishes the governance, transparency and accountability conditions that will regulate its operations. Based on the principles established by the law, and to ensure that the Financiera starts its operations with adequate structure and operating principles, the following measures have been taken:

- The management structure of Financiera Rural has been established, including: the nomination of its Governing Board (*Organo de Gobierno*), composed of representatives from the Federal Government, the social sector and an independent counsel. In addition, the following committees indicated in the law have to be established: Operations, Credit, Risk, and Human Resources.
- A Strategic Statement (*Programa Institucional*) has been approved, outlining the mission and objectives of the Financiera Rural, target markets and clients, instruments for providing credit, promoting investment and providing technical assistance. The Strategic Statement establishes a policy of limited credit expansion during the first year of operations (no more than 10%) with respect to the level of lending provided by Banrural in the second semester of 2002.
- A policy document has been approved by the Board of Financiera Rural establishing interest rate guidelines that will: (i) allow for financial sustainability of the Financiera Rural; (ii) encourage the development of private financial intermediaries, and (iii) will not crowd out in the medium term the capacity of the private financial sector to participate in rural financing.
- An Organizational Structure and a Regional Organization Plan has been approved establishing the branch network, geographical location and staffing. Initially, the number of branches will not exceed 99, employing about 660 staff (compared with 205 branches and 1831 employees in Banrural).
- A financial projections model for five-years has been produced that includes pro-forma balance sheets and income statements.

### ***Measures that will be taken in the near future to improve the efficiency and transparency of Financiera Rural***

- Financiera Rural will elaborate a Strategic Plan that provides:
  - the definition of the evaluation systems and risk control;



- the definition for the establishment of a management information system (MIS) and financial control system to support the management activities;
  - actions to take and objectives to promote the development of non-bank financial institutions in the rural sector;
  - the strategy and timeframe for the suspension of activities in the first tier lending operations;
  - the design of the second tier activities, including the timeframe for the migration to the second tier, the eligibility criteria for potential financial intermediaries, and the organizational structure of the second tier operations.
- Financiera Rural is elaborating operating manuals, including: (i) norms, policies, and procedures for issuing credit on the second tier and (ii) recovery procedures for bad credits. It is also testing parametric models to provide small credits.
  - To facilitate a follow up of the progress of Financiera Rural and to judge the success of its activities, Financiera Rural will present periodically a series of indicators of access to credit, quality of credit portfolio, results of the portfolio and operating efficiency.

### **III. Support from the Inter-American Development Bank**

The above summary description demonstrates our commitment with a strong program of reforms of the development banking sector. We consider that the financial and technical support of the Inter-American Development Bank has been and will continue to be a valuable tool in this stage of financial sector reforms. The proposed loan in support of the development of rural finance in Mexico would be within the framework of the program of support of financial sector reforms that the Inter-American Development Bank has been implementing in the last several years, which includes both technical assistance and lending operations in support of specific reforms in the sector. This program of support has established a constructive dialogue with the Bank and has contributed to achieving significant advances in the reform of the financial sector.

Sincerely

SUFRAGIO EFECTIVO. NO REELECCION

The Subsecretary

/ original signed /

## POLICY MATRIX

	<b>Actions completed prior to submission to the Board of Executive Directors</b>	<b>Disbursement of first tranche</b>	<b>Disbursement of second tranche</b>
<b>Objectives</b>			
		Macroeconomic policy remains consistent with program objectives.	Macroeconomic policy remains consistent with program objectives.
<b>Overall objective: Expansion and consolidation of the supply of rural financial services.</b>			
<b>Specific objectives:</b>			
<b>I. Increase the efficiency of the rural financing instruments used by the State, and improve coordination among the various government programs in the rural sector.</b>		A high-level working group of SHCP-coordinated rural financial services institutions has been set up, including Financiera Rural, FIRA, and others, to coordinate actions to promote the establishment and strengthening of rural financial intermediaries.	Progress has been made toward the working group's goal, and a strategy has been submitted for addressing any outstanding points.
<b>II. Establishment of Financiera Rural</b>	<p>The terms and conditions for liquidating the BANRURAL system have been issued.</p> <p>The Act Establishing Financiera Rural [Ley Orgánica de Financiera Rural (LOFR)] as a decentralized agency of the federal government and separate legal entity with its own assets, operating in the same sector as the Secretariat of Finance and Public Credit, has entered into force.</p> <p>The decree amending and supplementing article 2 of the 2002 Federal Revenue Law [Ley de Ingresos de la Federación] has entered into force. It authorizes the federal executive branch to fund up to MX\$48.878 billion for the liquidation of the BANRURAL system and establishment of Financiera Rural.</p>	<p>Financiera Rural has a strategic plan approved by the Governing Council, setting out the institution's financial objectives and identifying its customers and products. It also includes detailed financial projections for the next five years and should cover at least the following:</p> <ul style="list-style-type: none"> <li>– design of risk assessment and management systems;</li> <li>– design of management information systems;</li> <li>– actions and targets for promoting the development of rural nonbank financial intermediaries;</li> </ul>	<p>The actions set out in the strategy have been implemented. In particular, the following steps have been taken:</p> <ul style="list-style-type: none"> <li>– the number of branches has been kept below 100;</li> <li>– Financiera Rural's credit package has been evaluated by an independent consultant under terms of reference agreed with the Bank;</li> <li>– the planned management information system has been put in place and enables Financiera Rural to closely monitor the costs and profitability of credit operations, investments, branch offices, and lending and technical assistance programs;</li> </ul>

	<b>Actions completed prior to submission to the Board of Executive Directors</b>	<b>Disbursement of first tranche</b>	<b>Disbursement of second tranche</b>
	<p>Financiera Rural has an institutional program outlining its mission and objectives, target market, the main instruments to be used for providing credit and technical cooperation, and a lending plan for 2003.</p> <p>The following Financiera Rural instruments are in effect:</p> <ul style="list-style-type: none"> <li>(i) operating and lending permits;</li> <li>(ii) regulations governing the establishment, regionalization, and distribution of Financiera Rural regional coordination offices and branches; and</li> <li>(iii) its charter.</li> </ul>	<ul style="list-style-type: none"> <li>– design of second-tier banking activities, including the timeframe for transition to second-tier operations and their structure, with procedures for lessening conflicts of interest between first and second tier;</li> <li>– guidelines for a staff incentive policy to encourage prudent lending decisions and loan recovery;</li> <li>– organizational and budgetary separation of technical assistance services from Financiera Rural's other operations; and</li> <li>– how environmental issues are to be addressed.</li> <li>– The risk assessment and credit areas have been set up with the necessary staffing, technology, authority, and independence to perform their functions.</li> <li>– The lending manual for first-tier operations is in use.</li> <li>– Risk models are in place.</li> </ul>	<ul style="list-style-type: none"> <li>– actions to promote the development of rural nonbank financial intermediaries have taken place as planned, including implementation of a training program for rural financial intermediaries;</li> <li>– second-tier operations have begun as planned, including a structure for second-tier operations and implementation of the planned procedures for lessening conflicts of interest between first and second tier;</li> <li>– the planned staff incentive schemes aimed at achieving prudent lending decisions and loan recovery within the agreed parameters are being applied;</li> <li>– the budgetary and organizational separation of technical assistance services from Financiera Rural's other operations has taken place as planned; and</li> <li>– environmental issues are being addressed as planned.</li> <li>– Lending operations are being conducted in accordance with the first-tier lending manual specified in the first tranche.</li> <li>– A second-tier lending manual has been approved.</li> </ul>
		<ul style="list-style-type: none"> <li>– Financiera Rural complies with all regulations in force governing accounting records, portfolio ratings, loan loss provisioning, and risk management systems and procedures.</li> </ul>	<ul style="list-style-type: none"> <li>– Financiera Rural complies with all applicable regulations governing accounting records, portfolio ratings, loan loss provisioning, and risk management systems and procedures.</li> </ul>

	<b>Actions completed prior to submission to the Board of Executive Directors</b>	<b>Disbursement of first tranche</b>	<b>Disbursement of second tranche</b>
		<ul style="list-style-type: none"> <li>– During the second half of 2003 the growth of Financiera Rural's loan portfolio is maintained at 10% or less of the credit granted by BANRURAL in the second half of 2002.</li> <li>– Financiera Rural applies an interest-rate policy that both ensures its financial stability and fosters development of rural private intermediaries.</li> </ul>	<ul style="list-style-type: none"> <li>– Average portfolio / number of borrowers ("end customers") is maintained at less than 120,000 UDIs.</li> <li>– The interest-rate policy applied by Financiera Rural ensures its financial sustainability and fosters development of rural private intermediaries.</li> <li>– A policy that maintains net income at a level equal to or greater than zero is being applied. Net income is defined as: Revenues from the interest and commissions charged on loan and investment portfolios, plus budgetary transfers, minus the imputed cost of capital (at least the inflation rate), operating expenses, and loan portfolio provisioning.</li> </ul>
		<ul style="list-style-type: none"> <li>– Financiera Rural has agreed upon a pilot program with the Bank aimed at establishing models for the development of financial intermediaries serving the rural population, particularly low- and middle-income producers.</li> </ul>	<ul style="list-style-type: none"> <li>– Financiera Rural has set up pilot programs in at least two states aimed at establishing and/or strengthening financial intermediaries serving the rural population, particularly low- and middle-income producers.</li> </ul>